COMMODITY FUTURES IMPROVEMENTS ACT OF 1989

HEARINGS

BEFORE THE

SUBCOMMITTEE ON CONSERVATION, CREDIT,
AND RURAL DEVELOPMENT

OF THE

COMMITTEE ON AGRICULTURE
HOUSE OF REPRESENTATIVES

ONE HUNDRED FIRST CONGRESS

FIRST SESSION

ON

H.R. 2869

JULY 18 AND 20, 1989

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COMMODITY FUTURES IMPROVEMENTS ACT OF 1989

TUESDAY, JULY 18, 1989

House of Representatives,
Subcommittee on Conservation,
Credit, and Rural Development,
Committee on Agriculture,
Washington, DC.

The subcommittee met, pursuant to notice, at 10 a.m., in room 1302, Longworth House Office Building, Hon. Glenn English (chairman of the subcommittee) presiding.

Present: Representatives Tallon, Penny, Stallings, Nagle, Harris, Staggers, Espy, Sarpalius, Long, Coleman, Morrison, Gunderson, Combest, Grandy, and Holloway.

Also present: Representative E (Kika) de la Garza, chairman of the committee, and Representative Glickman, member of the committee.

Staff present: Bert R. Peña, staff director; Daniel E. Brinza, counsel; Fred J. Clark, associate counsel; Joseph Muldoon, assistant counsel; John E. Hogan, minority counsel; Alice Devine, minority associate counsel; Glenda L. Temple, clerk; Bill Cherry, Jim McDonald, James A. Davis, and David Ebersole.

OPENING STATEMENT OF HON. GLENN ENGLISH, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF OKLAHOMA

Mr. English. The hearing will come to order. Last February Chairman de la Garza directed this subcommittee to conduct an inquiry into the futures regulatory structure before taking up any reauthorization bills.

The work plan that we developed started with this statement:

> The purpose of the inquiry is to provide a sound factual basis for the Congress to use while considering the need for changes in futures industry operations and regulation. The ultimate goal is to assure the integrity of these markets.

The subcommittee has provided the sound factual basis during the past 5 months through the public briefings by our staff. Today we begin hearings aimed at the ultimate goal. The bill that Congressmen Coleman, Tim Penny, and I introduced last week makes drastic changes in some of the trading practices, especially in dual trading.

The bill restricts the practice of a floor broker trading for both his own account and that of customers, known as dual trading.

The bill restricts broker associations so they cannot do as a group what each member cannot do alone.

The bill establishes very strict goals which will improve the ability of the regulators to detect trading abuses.

The bill provides retail customers with additional protection against fraudulent sales practices.

The bill requires changes in the disciplinary committee and the governing board practices to reduce the chance for conflicts of interest.

The bill encourages CFTC to take the lead in initiating undercover operations.

The bill requires registration of floor traders, which means that every category in the industry will now be registered.

The bill puts teeth in the collection of civil penalties assessed by the CFTC, and it provides for nationwide service of process and venue.

The bill establishes a process of cooperation with foreign futures authorities.

Taken together, these provisions meet the ultimate goal of our work plan—to provide assurance about the integrity of the American futures markets.

I look forward to hearing our witnesses.

[H.R. 2869, the reports from the Commodity Futures Trading Commission and U.S. Department of Justice follow; the hearing continues on page 47.]

101ST CONGRESS
1ST SESSION

H. R. 2869

To amend the Commodity Exchange Act to improve the regulation of futures and options traded under rules and regulations of the Commodity Futures Trading Commission, establish registration standards for all exchange floor traders, restrict practices which may lead to the abuse of outside customers of the marketplace, reinforce development of exchange audit trails to better enable the detection and prevention of such practices, establish higher standards for service on governing boards and disciplinary committees of self-regulatory organizations, enhance the international regulation of futures trading, regularize the process of authorizing appropriations for the Commodity Futures Trading Commission, and for other purposes.

IN THE HOUSE OF REPRESENTATIVES

JULY 12, 1989

Mr. ENGLISH (for himself, Mr. COLEMAN of Missouri, and Mr. PENNY) introduced the following bill; which was referred to the Committee on Agriculture

---

A BILL

To amend the Commodity Exchange Act to improve the regulation of futures and options traded under rules and regulations of the Commodity Futures Trading Commission, establish registration standards for all exchange floor traders, restrict practices which may lead to the abuse of outside customers of the marketplace, reinforce development of exchange audit trails to better enable the detection and prevention of such practices, establish higher standards for service on governing boards and disciplinary committees of self-regulatory organizations, enhance the international regulation of futures trading, regularize the process of authorizing appropriations for the Commodity Futures Trading Commission, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE; TABLE OF CONTENTS.

(a) SHORT TITLE.—This Act may be cited as the "Commodity Futures Improvements Act of 1989".

(b) TABLE OF CONTENTS.—The table of contents is as follows:

TABLE OF CONTENTS

Sec. 1. Short title; table of contents.

TITLE I—LIMITATIONS ON CERTAIN TRADING PRACTICES

Sec. 101. Dual trading.
Sec. 102. Trading among members of broker associations.

TITLE II—ENHANCEMENT OF REGULATORY AND ENFORCEMENT ACTIVITIES

Sec. 201. Audit trails.
Sec. 202. Telemarketing fraud.
Sec. 203. Undercover operations and enforcement.
Sec. 204. Self regulatory organization disciplinary committees and governing boards.
Sec. 205. Required registration of floor traders.
Sec. 206. Enhancement of registration requirements.
Sec. 207. Enforcement of civil money penalties.
Sec. 208. Ethics training for registrants.
Sec. 209. Nationwide service of process and venue.

TITLE III—ASSISTANCE TO FOREIGN FUTURES AUTHORITIES

Sec. 301. Definition of foreign futures authority.
Sec. 302. Subpoena authority.
Sec. 303. Cooperation with foreign futures authorities.
Sec. 304. Investigative assistance to foreign futures authorities.
Sec. 305. Disclosure of information received from foreign futures authorities.
Sec. 306. Disclosure of information to foreign futures authorities.

TITLE IV—AUTHORIZATION OF APPROPRIATIONS; EFFECTIVE DATE

Sec. 401. Authorization of appropriations.
Sec. 402. Effective date.

TITLE I—LIMITATIONS ON CERTAIN TRADING PRACTICES

SEC. 101. DUAL TRADING.

(a) PROHIBITION.—Section 4j(1) of the Commodity Exchange Act (7 U.S.C. 6j) is amended to read as follows:

"(1)(A) The Commission shall issue regulations to prohibit dual trading by a floor broker in any contract market in which the Commission has determined the average daily trading volume to be equal to or greater than the threshold trading level established pursuant to this paragraph. For the purposes of this subsection, the threshold trading level shall be seven thousand contracts, based on a six-month moving average of the number of contracts traded on such contract market. However, if the Commission determines that the prohibition against dual trading creates undesirable price volatility, unacceptable widening of bid-ask spreads, or otherwise threatens the public interest, the Commission may increase or decrease the threshold trading level for such specific contract market. Any action by the Commission to adjust the threshold trading level of a contract market pursuant to this paragraph shall be reported to the Committee on Agriculture of the House of Representatives and the Committee on Agriculture, Nutrition, and Forestry of the Senate not later than three days after the Commission takes such action.

"(B) If the Commission has not determined to prohibit dual trading in a contract market pursuant to paragraph (C), the regulations issued by the Commission to implement paragraph (A) for such contract market shall—

"(i) define the term 'dual trading';

"(ii) specify the methodology by which the Commission shall determine the average daily trading volume of contracts on a contract market;

"(iii) provide for transition measures, as determined necessary by the Commission to prevent market disruption or to protect the public interest, for a contract market when the average daily trading volume on such contract market increases to or above, or decreases below, the threshold trading level;

"(iv) provide that a floor broker may dual trade in a newly designated contract market until the average daily trading volume on such contract market has increased to or above the threshold trading level;

"(v) provide for limited exceptions, as the Commission determines necessary, to the prohibition against dual trading required by paragraph (A) so that a broker may execute spread trades for such floor broker's own account or trade for such floor broker's own account for a brief period at the opening of the market in order to settle errors in trades made by such broker on such account on a previous trading day;

"(vi) provide that a floor broker affected by paragraph (A) shall indicate prior to the opening of trading for any given day whether such floor broker shall trade solely for such broker's own account or solely for customers' accounts for the entire trading day, with limited exceptions as determined by the Commission pursuant to subparagraphs (v) and (vii); and

"(vii) provide that a customer may designate an individual floor broker to execute such customer's orders for future delivery and trade for such broker's own account, notwithstanding the provisions of paragraph (A), if such customer, not less than once annually, executes a written form designating such broker by name.

Such regulations may also provide that if the average daily trading volume on a contract market increases to or above, or decreases below, the threshold trading level, any change in the status or dual trading otherwise required by paragraph (A) may be delayed or suspended if the Commission determines that such increase or decrease is a temporary, unusual occurrence.

"(C) Notwithstanding paragraphs (A) and (B), the Commission shall, as it determines necessary, make a determination from time to time, by rule, regulation, or order, whether or not dual trading, as that term may be defined in regulations issued by the Commission, by a floor broker may be allowed in contract markets where such trading is not prohibited pursuant to paragraph (A). If the Commission determines that dual trading by a floor broker shall be permitted, the Commission shall further determine the terms, conditions, and circumstances under which such dual trading shall be conducted. Any such determination shall, at a minimum, take into account the effect of dual trading upon the liquidity of trading in each market. Nothing in this subsection shall be construed to prohibit the Commission from making separate determinations for different contract markets when such are warranted in the judgment of the Commission, or to prohibit contract markets from setting terms and conditions more restrictive than those set by the Commission.

"(D) The Commission shall issue an order to exempt a board of trade from the provisions of paragraph (A) if such board of trade can demonstrate to the Commission that such board of trade's audit trail (i) can detect any and all instances of trading violations which the Commission determines to be attributable to dual trading, and (ii) is fully verifiable. Any order by the Commission to exempt a board of trade from the dual trading prohibition in paragraph (A) pursuant to this paragraph shall not become effective until after the expiration of ninety days after the date of transmittal of a report on the Commission's determinations regarding such board of trade to the Committee on Agriculture of the House of Representatives and the Committee on Agriculture, Nutrition, and Forestry of the Senate.".

(b) REGULATIONS.—The Commission shall issue the regulations required by section 4j(1) of the Commodity Exchange Act no later than two hundred seventy days after the effective date of this Act.

SEC. 102. TRADING AMONG MEMBERS OF BROKER ASSOCIATIONS.

(a) PROHIBITION.—Section 4j of the Commodity Exchange Act (7 U.S.C. 6j) is amended by adding at the end thereof the following new subsection:

"(3) It shall be unlawful, pursuant to regulations issued by the Commission—

"(A) for a member of a broker association, for or on behalf of any customer, to execute a transaction such that another member of the same broker association, trading for such other member's own account, or the account of the association, takes the opposite side of such transaction; or

"(B) for any member of a broker association to trade with another member of the same broker association, whether such brokers are trading for such brokers' own accounts, for customers, or for the account of the broker association, if such transactions in any month total more than 25 per centum of the total transactions of such broker; and

"(C) for any member of a broker association to engage in such other practices as the Commission determines necessary to prohibit or to curb abuses and otherwise protect the interests of customers from potential trading abuses by members of broker associations.

Such regulations shall include a definition of the term 'broker association'. Nothing in this subsection shall be construed to prohibit the Commission or contract markets from prohibiting trading by broker associations or their members, or from setting terms and conditions for such trading that are more restrictive than those set by this subsection.".

(b) REGULATIONS.—The Commission shall issue regulations to implement section 4j(3) of the Commodity Credit Exchange Act no later than two hundred seventy days after the effective date of this Act.

(c) REPORT TO CONGRESS.—The Commission shall determine whether the public interest would best be served by placing alternative restrictions on trading by broker associations and their members, and whether such broker associations, or trading by such broker associations, should be prohibited. The Commission shall report its determination and any recommendations by the Commission for regulatory or legislative initiatives to implement such recommendations to the Committee on Agriculture of the House of Representatives and the Committee on Agriculture, Nutrition, and Forestry of the Senate no later than two hundred seventy days after the effective date of the regulations required under this section.

TITLE II—ENHANCEMENT OF REGULATORY AND ENFORCEMENT ACTIVITIES

SEC. 201. AUDIT TRAILS.

(a) AUDIT TRAIL REQUIREMENTS FOR CONTRACT MARKETS.—Section 4g(2) of the Commodity Exchange Act (7 U.S.C. 6g) is amended by—

(1) inserting "(A)" after "(2)"; and

(2) adding at the end thereof the following new paragraph:

"(B)(i) Each contract market shall maintain or cause to be maintained by its clearinghouse a single record that shall show for each futures or options trade the transaction date, time of execution (as required by subparagraph (ii)), quantity, and, as applicable, underlying commodity, price or premium, delivery month or expiration date, whether the transaction involved a contract for future delivery or physical, put or a call, strike price, floor broker or floor trader buying, clearing member buying, floor broker or floor trader selling, clearing member selling, symbols indicating the buying and selling customer or option customer types and such other information as the Commission determines necessary. Such record shall enable such contract market to rapidly reconstruct an accurate record, as determined by the Commission, of the transactions executed on such contract market.

"(ii) For the purposes of subparagraph (i), the time of execution of a transaction shall be verifiable and shall—

"(a) be stated within an increment of no more than one minute in length, beginning not later than one year after the effective date of this paragraph; and

"(b) be stated within an increment of no more than thirty seconds in length, beginning not later than three years after the effective date of this paragraph.

"(iii) The Commission shall report on the status of compliance with the standards imposed by this section and report its findings to the Committee on Agriculture of the House of Representatives and the Committee on Agriculture, Nutrition, and Forestry of the Senate within one hundred and eighty days after the dates specified in clauses (B)(ii)(a) and (B)(ii)(b), respectively.

"(iv) The Commission shall—

"(a) determine whether the record required by this paragraph has enabled the affected contract markets to rapidly reconstruct an accurate, verifiable record of the transactions executed on such contract markets, as determined necessary by the Commission to provide for the effective enforcement of the applicable provisions of this Act and the rules or regulations thereunder;

"(b) determine whether the recording and reconstruction of the time and sequence of trades can more accurately represent the real times of such trades through the use of improved technologies or other means and determine whether any regulatory or legislative changes would be necessary or appropriate to implement such improvements; and

"(c) report its findings pursuant to this subparagraph to the Committee on Agriculture of the House of Representatives and the Committee on Agriculture, Nutrition, and Forestry of the Senate no later than five years after the effective date of this paragraph.".

"(b) AUDIT TRAIL COMPLIANCE AS CONDITION FOR CONTRACT MARKET DESIGNATION.—Section 5 of the Commodity Exchange Act (7 U.S.C. 7) is amended by adding at the end the following new paragraph:

"(h) When such board of trade demonstrates that every contract market for which such board of trade is designated complies with the requirements of sections 4g(2)(B)(ii)(a) and 4g(2)(B)(ii)(b) of this Act.".

SEC. 202. TELEMARKETING FRAUD.

"(a) PROHIBITION AGAINST TRADING ON NEW ACCOUNTS.—The Commodity Exchange Act is amended by adding after section 4p (7 U.S.C. 6p) the following new section:

"SEC. 4q. The Commission shall issue regulations to prohibit any person, who has solicited a customer by telephone to open a futures or options account from entering any orders for such account for three days after the customer signed any contract and a separate risk disclosure statement opening the account. Such regulations shall not apply to—

"(1) accounts opened solely for the purpose of making bona fide hedging transactions, as such term is defined by the Commission, consistent with the purposes of this Act; or

"(2) transactions that transfer positions in an existing futures or options account to another futures commission merchant or such other person as determined necessary by the Commission.

(3) accounts, other than the first account, opened by a customer with the same futures commission merchant.".

"(b) REGULATIONS.—The Commission shall issue the regulations required by section 4q of the Commodity Exchange Act no later than one hundred and eighty days after the date of enactment of this Act.

SEC. 203. UNDERCOVER OPERATIONS AND ENFORCEMENT.

Section 8(a) of the Commodity Exchange Act (7 U.S.C. 12(a)) is amended by—

(1) inserting "(1)" after "(a)"; and

(2) inserting at the end the following new paragraph:

"(2) In conducting investigations authorized under this subsection or other provision of this Act, the Commission shall continue, as the Commission determines necessary, to request the assistance of and cooperate with the appropriate Federal agencies in the conduct of such investigations, including undercover operations by such agencies.".

SEC. 204. SELF REGULATORY ORGANIZATION DISCIPLINARY COMMITTEES AND GOVERNING BOARDS.

(a) DISCIPLINARY COMMITTEES AND MAJOR VIOLATIONS.—Section 8c of the Commodity Exchange Act (7 U.S.C. 12c) is amended by adding at the end the following new subsections—

"(5) The Commission shall issue regulations to require the establishment of a system of contract market disciplinary committees. Under such system, each board of trade which has been designated as a contract market shall—

"(A) establish one or more disciplinary committees which shall be authorized by such board of trade to determine whether violations of the rules of the board of trade have been committed, to accept offers of settlement, and to impose appropriate penalties;

"(B) provide that disciplinary committees established pursuant to paragraph (A) be composed of members of the board of trade, or staff members of the board of trade, such that the committee, or any hearing panel formed by the committee to conduct disciplinary hearings, shall be composed of a majority of persons who are of a different trading status than the respondent; and

"(C) provide that a hearing panel formed by the committee to conduct disciplinary hearings may be composed of fewer than the total number of members of the committee.

For the purposes of paragraph (B), a disciplinary committee member's trading status shall be determined by whether such member is a: (1) floor broker or floor trader, (2) member of the board of trade other than a floor broker or floor trader, or (3) staff member of such board of trade.

"(6)(A) The Commission shall issue regulations requiring each contract market to establish and make available to the public a schedule of major violations of any rule within the disciplinary jurisdiction of such contract market.

"(B) The regulations issued by the Commission pursuant to this subsection shall prohibit any individual found to have committed a major violation of any rule within the disciplinary jurisdiction of a contract market from service on the governing board of any contract market or registered futures association, or on any disciplinary committee thereof, for a period of time to be determined by the Commission.".

(b) REGISTERED FUTURES ASSOCIATIONS.—Section 17 of the Commodity Exchange Act (7 U.S.C. 21) is amended by adding at the end the following new subsection:

"(r)(1) The Commission shall issue regulations requiring each registered futures association to establish and make available to the public a schedule of major violations of any rule within the disciplinary jurisdiction of such registered futures association.

"(2) The regulations issued by the Commission pursuant to this subsection shall prohibit any member of a registered futures association found to have committed a major violation of any rule within the disciplinary jurisdiction of such registered futures association from service on the governing board of any registered futures association or contract market, or on any disciplinary committee thereof, for a period of time to be determined by the Commission.".

(c) PUBLIC REPRESENTATION ON GOVERNING BOARDS.—(1) Section 5a of the Commodity Exchange Act (7 U.S.C. 7a) is amended by—

(A) striking "and" following the semicolon at the end of paragraph (11);

(B) striking "involved." at the end of paragraph (12) and inserting "involved; and"; and

(C) adding at the end the following new paragraph:

"(13) Ensure that outside members, as defined in regulations issued by the Commission, comprise at least 20 per centum of the governing board of such contract market.".

(2) Section 17(b) of the Commodity Exchange Act (7 U.S.C. 21), as amended by section 204(b)(2) of this Act, is amended by adding at the end the following new paragraph:

"(11) at least 20 per centum of the members of the governing board thereof are outside members, as defined in regulations issued by the Commission.".

(d) REGULATIONS.—The Commission shall issue regulations required by sections 5a(13), 8c(5), 8c(6), 17(b)(11), and 17(r) of the Commodity Exchange Act no later than one hundred and eighty days after the effective date of this Act.

SEC. 205. REQUIRED REGISTRATION OF FLOOR TRADERS.

(a) DEFINITION.—Section 2(a)(1)(A) of the Commodity Exchange Act (17 U.S.C. section 2) is amended by inserting after the sentence beginning "The words 'floor broker' " a new sentence as follows: "The words 'floor trader' shall mean any person who, in or surrounding any 'pit', 'ring', 'post', or other place provided by a contract market for the meeting of persons similarly engaged, shall purchase or sell solely for such person's own account any commodity for future delivery on or subject to the rules of any contract market.".

(b) FLOOR TRADER REGISTRATION.—Section 4e of the Commodity Exchange Act (7 U.S.C. section 6e) is amended to read as follows:

"It shall be unlawful for any person to act as floor trader in executing purchases and sales, or as floor broker in executing any orders for the purchase or sale, of any commodity for future delivery, or involving any contracts of sale of any commodity for future delivery, on or subject to the rules of any contract market unless such person shall have registered, under this Act, with the Commission as such floor trader or floor broker and such registration shall not have expired nor been suspended nor revoked.".

(c) REGISTRATION PROCEDURE.—Section 4f(1) of the Commodity Exchange Act (7 U.S.C. section 6f(1)) is amended by striking the words "or floor broker" and inserting the words "floor broker, or floor trader".

(d) REPORTS; BOOKS AND RECORDS.—Section 4g(1) of the Commodity Exchange Act (7 U.S.C. section 6g (1)) is amended by striking the words "or floor broker" and inserting the words "floor broker, or floor trader".

(e) JURISDICTION OF THE STATES.—(1) Section 6d(1) of the Commodity Exchange Act (7 U.S.C. section 13a-2(1)) is amended by striking the words "or floor broker" and inserting the words "floor broker, or floor trader".

(2) Section 6d(8)(A) of the Commodity Exchange Act (7 U.S.C. section 13a-2(8)(A)) is amended by inserting ", floor trader," after the words "floor broker".

(f) COMMISSION AUTHORITY TO REGISTER FLOOR TRADERS.—Section 8a(1) of the Commodity Exchange Act (7 U.S.C. 12a(1)) is amended by striking out the words "and floor brokers" and inserting the words "floor brokers, and floor traders".

(g) REFUSAL TO REGISTER.—(1) Section 8a(2)(C)(i) of the Commodity Exchange Act (7 U.S.C. 12a(2)(C)(i)) is amended by inserting "floor trader," after "floor broker,".

(2) Section 8a(2)(D)(ii) of the Commodity Exchange Act (7 U.S.C. 12a(2)(d)(ii)) is amended by inserting "floor trader," after "floor broker,".

(3) Section 8a(3)(E)(ii) of the Commodity Exchange Act (7 U.S.C. 12a(3)(E)(ii)) is amended by inserting "floor trader," after "floor broker,".

(h) REGULATIONS.—The Commission shall issue any regulations necessary to implement the provisions of this section no later than one hundred and eighty days after the effective date of this Act.

SEC. 206. ENHANCEMENT OF REGISTRATION REQUIREMENTS.

(a) Section 8a(2)(C) of the Commodity Exchange Act (7 U.S.C. 12a(2)) is amended by—

(1) inserting immediately after the word "decree" the second time it appears "or solely on the basis of an order, judgment or decree which is not deemed to constitute a disqualification from registration by the regulatory agency which initiated the injunctive action";

(2) in clause (ii) striking "involving any transaction in or advise concerning contracts of sale of a commodity for future delivery," and inserting "where such activity involves embezzlement, theft, extortion, fraud, fraudulent conversion, misappropriation of funds, securities or property, forgery, counterfeiting, false pretenses, bribery, gambling or deception of customers, or";

(3) inserting a semicolon immediately after "Act"; and

(4) striking "or concerning securities;".

(b) Section 8a(2)(D)(iii) of the Commodity Exchange Act (7 U.S.C. 12a(2)(D)(iii)) is amended by—

(1) striking "or" immediately before "gambling,"; and

(2) inserting "or deception of customers," immediately after "gambling,".

(c) Section 8a(2)(D)(iv) of the Commodity Exchange Act (7 U.S.C. 12a(2)(D)(iv)) is amended by—

(1) inserting "371, 1001," immediately after "152,";

(2) striking "or" immediately after "1342";

(3) inserting "1503, 1623, 1961–1963, or 2314," immediately after "1343,"; and

(4) inserting "or section 7201 or 7206 of title 26," immediately after "18,".

(d) Section 8a(2)(E) of the Commodity Exchange Act (7 U.S.C. 12a(2)(E)) is amended by—

(1) striking "by any court of competent jurisdiction," and inserting "in a proceeding brought";

(2) in clause (i) inserting "the Racketeer Influenced Corrupt Organizations Act," immediately after "1977,";

(3) in clause (i) striking out "or" immediately after "bribery,"; and

(4) in clause (i) inserting "or deception of customers," immediately after "gambling,".

(e) Section 8a(2)(G) of the Commodity Exchange Act (7 U.S.C. 12a(2)(G)) is amended by—

(1) striking "subparagraphs (A) through (F) of this paragraph," and inserting "sections 8a(2) and 8a(3),";

(2) striking "material" the first time it appears, and inserting "materially"; and

(3) strike "application;" and insert "application or any update thereto;".

(f) Section 8a(3)(D) of the Commodity Exchange Act (7 U.S.C. 12a(3)(D) is amended by—

(1) inserting "pled guilty to or" immediately after "person";

(2) inserting a comma after "section" the first time it appears;

(3) striking "within ten years preceding the filing of the application or at any time thereafter,";

(4) striking ", including a felony"; and

(5) striking ", more than" and inserting "more than".

(g) Section 8a(3)(E) of the Commodity Exchange Act (7 U.S.C. 12a(3)(E) is amended by—

(1) inserting "pled guilty to or" after "person";

(2) striking "within ten years preceding the filing of the application for registration or at any time thereafter";

(3) in clause (iii) striking "or" immediately after "bribery";

(4) in clause (iii) inserting "deception of customers, moral turpitude or conduct inconsistent with just

and equitable principles of trade," immediately after the word "gambling";

(5) in clause (iv) inserting "371," immediately after "152,"; and

(6) in clause (iv) inserting "or section 7203, 7204, 7205, or 7207 of title 26," after "18,".

(h) Section 8a(3)(G) of the Commodity Exchange Act (7 U.S.C. 12a(3)(G) is amended by—

(1) striking "material" the first time it appears, and inserting "materially";

(2) striking the comma after "application";

(3) inserting "or any update thereto," after "application";

(4) striking "thereunder, or" and inserting "thereunder,"; and

(5) inserting after "Commission" the words "or in any registration disqualification proceeding".

(i) Section 8a(3)(H) of the Commodity Exchange Act (7 U.S.C. 12a(3)(H)) is amended by inserting immediately after "State court" ", in a United States military court,".

(j) Section 8a(3)(J) of the Commodity Exchange Act (7 U.S.C. 12a(3)(J)) is amended by—

(1) striking "or" after the first reference to "association";

(2) inserting "or any foreign regulatory body that the Commission has recognized as having a comparable regulatory program," after the first reference to "organization";

(3) striking "or" after the second reference to "association"; and

(4) striking "organization;" and inserting "organization, or foreign regulatory body;".

(k) Section 8a(3)(K)(i) of the Commodity Exchange Act (7 U.S.C. 12a(3)(K)(i)) is amended by—

(1) striking "or" immediately after "bribery,"; and

(2) inserting ", deception of customers, or conduct inconsistent with just and equitable principles of trade," immediately after "gambling".

SEC. 207. ENFORCEMENT OF CIVIL MONEY PENALTIES.

Section 6(d) of the Commodity Exchange Act (7 U.S.C. 9a), is amended to read as follows:

"(d)(1) In determining the amount of the money penalty assessed under paragraph (b), the Commission shall consider the appropriateness of such penalty to the gravity of the violation.

"(2) Unless the person against whom a money penalty is assessed under paragraph (b) shows to the satisfaction of the Commission within fifteen days from the expiration of the period allowed for payment of such penalty that either an appeal as authorized by paragraph (b) has been taken or payment of the full amount of the penalty then due has been made, at the end of such fifteen-day period and until such person shows to the satisfaction of the Commission that payment of such amount with interest thereon to date of payment has been made: (A) such person shall be prohibited from trading on all contract markets and (B) if such person is registered with the Commission, such registration shall be suspended.

"(3) If a person against whom a money penalty is assessed under paragraph (b) takes an appeal and if the Commission prevails or the appeal is dismissed, unless such person shows to the satisfaction of the Commission that payment of the full amount of the penalty then due has been made by the end of thirty days from the date of judgment on the appeal: (A) such person shall be prohibited from trading on all contract markets and (B) if such person is registered with the Commission, such registration shall be suspended. If the person upon whom the money penalty has been imposed fails to pay such penalty after the lapse of the period allowed for appeal or after the affirmance of such penalty, the Commission may refer the matter to the Attorney General who shall recover such penalty by action in the appropriate United States district court.".

SEC. 208. ETHICS TRAINING FOR REGISTRANTS.

Section 4p of the Commodity Exchange Act (7 U.S.C. 6p) is amended by—

(1) inserting "(1)" after "Sec. 4p."; and

(2) adding after the existing section 4p(1), as so redesignated, the following new subsection:

"(2) The Commission shall issue regulations to require new registrants, within six months after receiving such registration, to attend a training session, and all other registrants to attend periodic training sessions, to ensure that registrants understand their responsibilities to the public under this Act, including responsibilities to observe just and equitable principles of trade, any rule or regulation of the Commission, any rule of any appropriate contract market, registered futures association, or other self-regulatory organization, or any other applicable Federal or State law, rule or regulation.".

(c) The Commission shall issue the regulations required by section 4p(2) of the Commodity Exchange Act no later than one hundred and eighty days after the effective date of this Act.

SEC. 209. NATIONWIDE SERVICE OF PROCESS AND VENUE.

Section 22(c) of the Commodity Exchange Act (7 U.S.C. 25(c)) is amended to read as follows:

"(c) The United States district courts shall have exclusive jurisdiction of actions brought under this section. Any such action must be brought within two years after the date the cause of action accrued. Any action brought under subsection (a) of this section may be brought in any district wherein the defendant is found or is an inhabitant or transacts business, or in the district wherein any act or transaction constituting the violation occurred, and process in such action may be served in any district of which the defendant is an inhabitant or wherever the defendant may be found.".

TITLE III—ASSISTANCE TO FOREIGN FUTURES AUTHORITIES

SEC. 301. DEFINITION OF FOREIGN FUTURES AUTHORITY.

Section 2(a)(1)(A) of the Commodity Exchange Act (7 U.S.C. 2) is amended by inserting at the end a new sentence as follows: "The term 'foreign futures authority' means any foreign government, or any department, agency, governmental body or regulatory organization empowered by a foreign government to administer or enforce laws, rules or regulations as they relate to futures or options matters, or any department or agency of a political subdivision of a foreign government empowered to administer or enforce laws, rules or regulations as they relate to futures or options matters.".

SEC. 302. SUBPOENA AUTHORITY.

Section 6(b) of the Commodity Exchange Act (7 U.S.C. 15) is amended by inserting in the third sentence thereof following the word "Act" the second time it appears: "or for purposes of any action taken under Section 12(f) of this Act,".

SEC. 303. COOPERATION WITH FOREIGN FUTURES AUTHORITIES.

Section 12(a) of the Commodity Exchange Act (7 U.S.C. 16(a)) is amended by inserting after "thereof," the following: "any foreign futures authority, or any department or agency of a foreign government or political subdivision thereof,".

SEC. 304. INVESTIGATIVE ASSISTANCE TO FOREIGN FUTURES AUTHORITIES.

Section 12 of the Commodity Exchange Act (7 U.S.C. 16) is amended by adding at the end the following new subsection:

"(f) On request from a foreign futures authority, the Commission may, in its discretion, provide assistance in accordance with this section if the requesting authority states that the requesting authority is conducting an investigation which it deems necessary to determine whether any person has violated, is violating, or is about to violate any laws, rules or regulations relating to futures or options matters that the requesting authority administers or enforces. The Commission may conduct such investigation as the Commission deems necessary to collect information and evidence pertinent to the request for assistance. Such assistance may be provided without regard to whether the facts stated in the request would also constitute a violation of the laws of the United States. In deciding whether to provide assistance under this section, the Commission shall consider whether (1) the requesting authority has agreed to provide reciprocal assistance to the Commission in futures and options matters; and (2) compliance with the request would prejudice the public interest of the United States. Notwithstanding any other provision of law, the Commission may accept payment and reimbursement, in cash or in kind, from a foreign futures authority, or made on behalf of such authority, for necessary expenses incurred by the Commission, its members, and employees in carrying out any investigation pursuant to this section or in providing any other assistance to a foreign futures authority. Any payment or reimbursement accepted shall be considered a reimbursement to the appropriated funds of the Commission.".

SEC. 305. DISCLOSURE OF INFORMATION RECEIVED FROM FOREIGN FUTURES AUTHORITIES.

Section 8 of the Commodity Exchange Act (7 U.S.C. 12) is amended—

(1) by inserting at the end of subsection 8(a)(1), as redesignated by section 203 of this Act, the following new sentence: "The Commission shall not be compelled to disclose any information or data obtained by

the Commission from a foreign futures authority if the foreign futures authority has in good faith represented to the Commission that such disclosures would be contrary to the laws of the foreign country from which it was obtained; however, nothing in this subsection shall prevent the Commission from disclosing publicly any information or data obtained by the Commission from a foreign futures authority when such disclosure is made in connection with a congressional proceeding, an administrative or judicial proceeding commenced by the United States or the Commission, in any receivership proceeding commenced by the United States or the Commission, or in any bankruptcy proceeding in which the Commission has intervened or in which the Commission has the right to appear and be heard under title 11 of the United States Code."; and

(2) by inserting at the end of subsection 8(b) the following new sentence: "Nothing in this subsection shall apply to the disclosure of data or information obtained by the Commission from a foreign futures authority.".

SEC. 306. DISCLOSURE OF INFORMATION TO FOREIGN FUTURES AUTHORITIES.

Subsection (e) of section 8 of the Commodity Exchange Act (7 U.S.C. 12(e)) is amended—

(1) by inserting in the fifth sentence after "jurisdiction," the first time it appears the following: "or any foreign futures authority";

(2) by inserting in the fifth sentence after "such" the following: "foreign futures authority,";

(3) by inserting in the last sentence after "information to a" the following: "foreign futures authority or to a";

(4) by inserting in the last sentence after "disclosed by such" the following: "foreign futures authority,"; and

(5) by inserting in the last sentence after "or agency thereof" the following: "or foreign futures authority".

TITLE IV—AUTHORIZATION OF APPROPRIATIONS; EFFECTIVE DATE

SEC. 401. AUTHORIZATION OF APPROPRIATIONS.

Section 12(d) of the Commodity Exchange Act (7 U.S.C. 16(d)) is amended to read as follows:

"(d) There are authorized to be appropriated to carry out this Act—

"(1) $40,000,000 for fiscal year 1990; and

"(2) $44,500,000 for fiscal year 1991.".

SEC. 402. EFFECTIVE DATE.

The provisions of, and amendments made by, this Act shall be effective upon enactment.

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OFFICE OF
THE CHAIRMAN

September 6, 1989

The Honorable E (Kika) de la Garza
Chairman, Committee on Agriculture
U.S. House of Representatives
1301 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Chairman:

The Commission is pleased to express its views on H.R. 2869, the Commodity Futures Improvements Act of 1989, as reported by your Committee on August 2, 1989. We strongly support the purpose of this bill of increasing public confidence in the integrity of futures markets by diminishing the potential for trade practice abuse and strengthening the Commission's regulatory system. Although we have some reservations over certain aspects of the bill, we congratulate you and the other members of the Committee, particularly Subcommittee Chairman English and Subcommittee Ranking Minority Member Coleman, in developing this important and far-reaching legislation.

There are a number of provisions in the bill that address alleged wrongdoings that have been set forth in the indictments and administrative settlements announced as a result of the investigation in Chicago. At this time, we do not believe that these actions have disclosed information that requires any other statutory changes. If we find that additional changes in the law are necessary, however, we will promptly recommend them to the Committee.

I would like to summarize our position on the bill in preparation for consideration of H.R. 2869 by the House.

Dual Trading

As I noted in my earlier testimony, the Commission has undertaken a study of certain issues regarding dual trading. We have made substantial progress and we are confident that the study will be completed early this fall. Based on the results of the study, we expect to initiate a rulemaking concerning dual trading. We believe that complex issues such as those involved in dual trading are addressed most effectively, and with the greatest flexibility, through rulemaking under our current statutory authority rather than through amendment to the Commodity Exchange Act.

In any event, with regard to the specific provisions of H.R. 2869, while we have some concerns over a dual trading prohibition based on specific volume levels, we believe the bill provides for sufficient flexibility to enable the Commission to increase or decrease these statutory levels on a market-by-market basis should it determine that such adjustments are warranted. We are also pleased that the bill recognizes that the audit trail alone, as a record analysis system, cannot detect all types of trade practice violations and therefore is not the sole mechanism upon which an exchange may base its request for an exemption from the dual trading prohibition. Instead, the bill sets forth an exemptive standard under which the Commission may assess the overall effectiveness of an exchange's compliance programs rather than being obliged to determine that such programs detect all instances of a particular abuse.

We still believe, however, that both the exemptive and temporary waiver standards need to be modified. First, 60 days is too short a time period in which to complete the initial evaluation of exchange programs under the exemptive standard. This is especially so since it is likely that most, if not all, exchanges would file exemptions at about the same time, which would have severe resource implications for the Commission. Since section 5a(12) of the Act gives the Commission six months to review a single exchange rule submission, H.R. 2869 should give the Commission at least six months within which to complete its initial evaluation.

The temporary waiver process also requires amendment. In order to make the determination called for -- that the exchange is likely to satisfy the exemptive standard -- the Commission essentially would have to perform a full analysis as to whether the exchange had met its burden of meeting the exemption standard. We suggest that the bill be amended to permit the Commission to develop appropriate waiver standards as part of the regulations concerning dual trading.

Audit Trail

An improved audit trail has been a long-held Commission goal and we have moved aggressively toward this goal since 1986. The trade timing standard currently in effect under Commission rules is a one-minute standard. We are firmly committed to improving the audit trail in the ways that are most effective in detecting trade practice abuse. In this regard, we believe the requirement to decrease the trade timing standard to 30 seconds or less in three years should be deleted from H.R. 2869. The Commission needs maximum flexibility in determining whether a 30-second standard is appropriate for particular exchanges in particular circumstances. In other circumstances other audit trail improvements may be more effective in detecting and preventing trade practice abuse than a 30-second standard. For example, it may be more effective to move toward on-line order routing, execution and trade reporting systems, and to impose more rigorous trading, record collection, time stamping and record-keeping requirements, which would improve audit trails and provide other benefits. The Commission has recently announced proposed rules in this area.

H.R. 2869 also would prevent the Commission from designating an exchange to trade a new futures contract unless the exchange can show that every contract market for which it is presently designated complies with the audit trail requirements imposed by new section 4g(b)(2) of the Act. Although we understand that for purposes of compliance, the Commission may set trade timing verifiable accuracy levels at less than 100%, we nevertheless are concerned that an exchange which exceeds these levels in virtually all cases must be denied a new designation. If, for example, one contract market within the exchange is unable to achieve that level for a given period because of particularly heavy volume or volatility, this is overly restrictive and could prevent new products from being introduced to the detriment of the nation's economy. We believe the better approach is that taken under present law where the Commission assesses an exchange's overall performance prior to designation. As noted above, this approach is also more consistent with the exemptive standard the bill provides in the dual trading provisions.

Broker Associations

We agree that it is important for the Commission to define and identify broker associations for the purposes of surveillance and compliance programs and we are currently interviewing broker association participants and studying current exchange practices. Our study should be completed early this fall. We believe that rulemaking is more appropriate than setting a statutory limit on trading between association members as set forth in H.R. 2869. Effective monitoring of broker association activities may well require restrictions to be tailored to particular markets. In this regard, paragraph (3) of new section 4j(c) could form the basis of this type of rulemaking, and in our view, would be sufficient statutory coverage of this area at this time.

Telemarketing Fraud

H.R. 2869 limits its focus on telemarketing to members of futures associations against whom some action has been taken. We believe the scope of this provision should be broadened to empower the Commission to set the standards under which the association would allow members to solicit new accounts by telephone.

Undercover Authority

We are pleased that H.R. 2869 recognizes the importance of cooperative law enforcement with other agencies. We also strongly support the bill's intention to send a signal that these types of undercover activities may be undertaken at any time.

Disqualification from Service on Disciplinary Committees and Governing Boards

The Commission supports the provision that would bar individual members with significant disciplinary records from service on disciplinary or governing panels of exchanges and futures associations for a fixed period of time. We are already undertaking a rulemaking in this area.

Composition of Disciplinary Committees and Governing Boards

We are concerned that the requirement in H.R. 2869 that a majority of committee members be from a different sector of exchange membership than the person appearing before the committee may diminish the technical expertise of the group enough to slow down the process and to render a less effective and appropriate decision. We suggest that the requirements regarding committee composition and the stages in the disciplinary process should be addressed in a flexible manner allowing for diversity across exchanges.

H.R. 2869 also requires that 20 percent of exchange and futures association governing boards be composed of "outside" members, as defined by the Commission. While we favor "outside" members and will develop a broad definition to include groups such as market users, we continue to be concerned that a statutory quota system may not always achieve the desired results. In 1985 we found that the performance of public directors sometimes was limited by directors' absenteeism, failure to prepare sufficiently, and failure to provide expert assistance. These factors should be recognized and considered before further restrictions concerning board membership become part of the statute or the Commission's rules.

Required Registration of Floor Traders

The Commission supports this provision.

Enhancement of Registration Requirements

The Commission supports this provision.

Enforcement of Civil Money Penalties

The Commission supports this provision.

Ethics

The Commission supports this provision.

Nationwide Service of Process and Venue

The Commission supports this provision.

Increased Penalties for Felony Convictions

The Commission supports this provision.

Contract Market Emergency Actions

During its markup, the Committee modified H.R. 2869 to provide that an exchange need not obtain Commission approval before it may take emergency action, although it must make every effort to give the Commission prior notice of such an action. While we continue to believe that there is no necessity for any change in exchange emergency authority, we support the Committee's approach as more in keeping with the concept of exchange accountability and responsibility as a self-regulator.

The Committee bill also provides that within ten days (or as soon as practicable) after receipt of an exchange emergency rule and explanation, the Commission must approve or disapprove the rule and file a report with Congress justifying its action. We understand that under this provision, the timing of the Commission's response may be tailored so as to avoid undue market consequences. For example, if there were more than ten trading days remaining in a contract after the exchange action, the Commission could defer its decision and not report until trading ended, if prior action might interfere with orderly trading.

We also understand that in providing for Commission approval of an emergency rule within the ten-day time period, the Committee did not intend to require that the Commission complete its final analysis of the exchange action in that time or to immunize the exchange from later scrutiny of its emergency actions. In this regard, we believe the Committee report should make clear that Commission approval would not insulate the exchanges from subsequent civil liability to market participants or from Commission regulatory or enforcement accountability under the Act, should these be appropriate when all relevant facts and circumstances are reviewed by the Commission or otherwise become known at a later date.

GAO Study of Delivery Points

The Commission supports this provision.

Trading on Material Non-public Information

The Commission supports new section 9(f) of the Act which will make it a felony for employees of self-regulatory organizations or members of their governing boards and committees, to use or disclose, contrary to Commission regulations, material, non-public information for non-official purposes. The Commission's current regulations already address this type of activity.

H.R. 2869 would also add new sections 9(g) and 9(h) to the Act. Section 9(g) would make it a felony for an individual, contrary to Commission regulations, to use as the basis for any commodity futures or option transaction for his or her own account, any material, non-public information as to present or future cash commodity or commodity future or option transactions of any person of whom the individual is an employee or principal where the aggregate of such transactions are in amounts in excess of reporting levels specified by the Commission pursuant to section 4i of the Act. Section 9(h) would make it a felony for any such employee or principal to disclose such information concerning his firm's transactions with the intent that the recipient engage in commodity futures or option transactions on the basis of the information and where the disclosure is unrelated to the firm's business. The Commission understands that its regulations to implement section 9(g) may provide for appropriate exemptions, for example, where commodity producers who are also employees of grain elevators establish their own hedging positions.

The Commission has some concerns over these two provisions. We have not found problems associated with the misuse of proprietary information as contemplated by proposed sections 9(g) and 9(h) by employees of reportable traders. And while as a general matter we agree that employees should not misuse their firms' information for personal gain in the futures or options markets, we believe more information regarding the nature and magnitude of this problem is needed in order to justify statutory solutions like those in the bill.

As an alternative, we are prepared to use our existing rulemaking authority to address this issue, to adopt any regulatory prohibitions that may be warranted and to report to Congress on any criminal provisions or other legislative changes that may be necessary. A rulemaking effort will permit us to focus on such complex questions as the type of firm information on cash and futures positions that should be protected from misappropriation, which employees and principals should be covered, whether trading and disclosure rules should be keyed only to reportable traders as in the bill or be more broadly based, the scope of appropriate exemptions for personal hedging and other legitimate purposes and whether the rules should apply to trading and disclosure in related commodity groups. We would welcome report language endorsing this approach.

Competitiveness Study

The Commission supports this provision.

Monitoring of Hedge Exemptions

The Commission supports this provision.

Assistance to Foreign Futures Authorities

The Commission supports this provision.

Period of Reauthorization

We support the stated intention of H.R. 2869 to make the Commodity Futures Trading Commission a permanent agency. Permanent authorization is consistent with regular and active Congressional oversight of the agency which the Commission has always supported.

We appreciate this opportunity to present our views to the Committee. Please be assured that the concerns expressed above with respect to certain aspects of H.R. 2869 do not detract from our support of the goals of this bill.

Very truly yours,
Wendy L Gramm
Wendy L. Gramm
Chairman

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OFFICE OF
THE CHAIRMAN

September 12, 1989

The Honorable E (Kika) de la Garza
Chairman, Committee on Agriculture
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1301 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Chairman:

As you will recall, on January 23 and July 17, 1989, we submitted for consideration by the House Agriculture Committee our recommendations for amendments to the Commodity Exchange Act. As explained in those submissions, these amendments would enhance the enforcement of the Act by providing for cooperation with foreign futures law enforcement authorities, nationwide service of process and venue in private rights of action, flexibility in imposing civil monetary penalties and registration of floor traders. I am pleased that H.R. 2869 as reported by the Committee includes all of these proposals.

Title III of the bill would permit the Commission to assist foreign futures authorities. The bill's definition of foreign futures authority includes a broad range of authorities, including independent governmental regulatory agencies, executive agencies, local governmental authorities, self-regulatory organizations and criminal authorities that administer or enforce rules or regulations as they relate to futures and options matters.

In particular, the bill would permit the Commission to conduct investigations upon the request of a foreign futures authority without regard to whether the facts stated in the request constitute a violation of U.S. law. To facilitate the development of a working relationship with authorities that have the broadest legal mandate to oversee futures and options matters, it is expected that the Commission will act upon such investigative requests from a single authority or only a few authorities in each country, instead of from a wide range of self-regulatory organizations with varying responsibilities. In providing assistance, the Commission would be required to consider the public interest and the agreement of the foreign futures authority to provide reciprocal assistance to the Commission. The Commission believes that investigative assistance from foreign authorities would be a powerful tool in effectively enforcing the Commodity Exchange Act in investigations that require the gathering of information from foreign sources. The Commission expects the availability of its assistance to foreign futures authorities to act as a strong inducement to these authorities to obtain similar authority to assist the Commission. As you are aware, the proposed investigative authority closely parallels the authority obtained by the Securities and Exchange Commission last year in section 6 of the Insider Trading and Securities Fraud Enforcement Act of 1988.

In addition, Title III's amendment to section 8(a) of the Act provides protection from compelled disclosure of information identified in good faith to the Commission by a foreign futures authority as protected from such disclosure under foreign law. However, section 8(a) does not preclude the disclosure of such information in the proceedings referenced therein. This protection from compelled disclosure is necessary to achieve the full measure of effective cooperation with foreign futures authorities in enforcement matters, and is consistent with other provisions of section 8 of the Act which already protect certain categories of information from public disclosure, in accordance with subsection (b)(3)(B) of section 552 of title 5, United States Code.

Section 209 of H.R. 2869 would amend the Act to authorize nationwide service of process in private actions brought under section 22 of the Act, the provision which permits customers to seek damages for violations of the Act. The amendment would empower U.S. district courts sitting anywhere in the United States to issue process against a particular defendant, without regard to whether the plaintiff can establish that the defendant had minimum contacts with the state in which the U.S. district court is located. The proposal also includes special venue provisions for section 22 actions to grant plaintiffs greater choice in their selection of the particular forum in which to bring their action.

The amendment is prompted by a 1987 Supreme Court decision which ruled that authorization for nationwide service of process in private actions was not implicit in the Commodity Exchange Act. As a result, without this amendment plaintiffs may be precluded from suing non-U.S. defendants anywhere in this country. And as against U.S. defendants, private plaintiffs will be subject to the burden and expense of proving that the defendant is amenable to service under a state "long-arm statute," and, failing this, they may be relegated to suing in an inconvenient forum. This amendment would place commodity futures customers on the same footing as securities customers, in circumstances where there arises a need for resort to federal court litigation, because the federal securities laws expressly provide for nationwide service of process.

Section 207 of H.R. 2869 would amend the Act to (1) eliminate the requirement that CFTC consider a wrongdoer's financial circumstances in assessing a civil penalty and (2) provide that if the wrongdoer does not pay the penalty when due, his existing registration with the CFTC would automatically be suspended and the wrongdoer would automatically be prohibited from trading on all exchanges. This provision will facilitate and provide more flexibility to the Commission's administrative law enforcement process in selecting appropriate sanctions and will provide additional statutory incentives to wrongdoers to pay penalties promptly. Congress has already provided such incentives in connection with unpaid reparations judgments.

Under existing section 6(d) of the Act, the Commission must not only consider the gravity of the violation in imposing a monetary penalty, but also evidence relating to the penalty's effect on the wrongdoer's net worth or ability to continue in business. Because this type of evidence is generally controlled by respondents, the Commission has required them to come forward with a showing that a proposed penalty is excessive in light of their net worth or ability to continue in business. Respondents that did not wish to produce such evidence have been permitted to waive the financial inquiry mandated by the Act. The Commission has viewed its waiver approach as consistent with Congress' intention that respondents have protection from excessive civil penalties. However, disputes over the proper application of section 6(d) have generated considerable litigation, including several appeals to the Courts of Appeals. This litigation itself has been an additional burden on the Commission's enforcement program. Some courts have interpreted the law less flexibly than the Commission and have required development of an evidentiary record on net worth or ability to pay whenever the Commission imposes a civil monetary penalty in an adjudicatory proceeding. This is particularly difficult when the respondent, who possesses the information, fails or refuses to provide the evidence for the record.

Another troubling aspect of the net worth inquiry has come to light where a respondent claims insolvency. Specifically, a United States bankruptcy court has blocked the Commission's prosecution of an administrative case, in part because the court was persuaded that the Commission's obligation to consider net worth would interfere with the respondents' personal bankruptcy reorganizations. The Commission has appealed that decision.

Thus, the Commission believes that the statutory requirement to consider financial circumstances has been misconstrued to become an inhibition to effective enforcement of the Act and should be deleted as provided by section 207 of the bill. This deletion would not limit the Commission's discretion to consider factors relevant to the remedial purposes of existing section 6(d). These factors may include: (1) the harm to other persons resulting from the violation; (2) monetary or other benefit to the wrongdoer; (3) whether there has been any restitution made to persons injured; (4) prior sanctions imposed by the CFTC or other authorities; (5) factors tending to show mitigation or rehabilitation; and (6) the need to deter the wrongdoer and others from committing these violations.

Registration of floor traders as provided by section 205 of H.R. 2869 would also assist law enforcement. Historically, floor traders have not been required to register under the Act because they do not handle customer trades or money and because exchange rules have established criteria governing their access to the floor. However, if floor traders collude with brokers in violation of the Act or of Commission regulations, they should be subject to the same regulatory sanctions. By requiring floor traders to register, the bill would subject them to statutory disqualification and fitness requirements like other registrants.

Thank you very much for your consideration and assistance during this year's reauthorization process.

Sincerely,
Wendy Gramm
Wendy L. Gramm
Chairman

U.S. Department of Justice
Office of Legislative Affairs

Office of the Assistant Attorney General

Washington, D.C. 20530

September 12, 1989

The Honorable E de la Garza
Chairman
Committee on Agriculture
U.S. House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

This is to reiterate the views of the Department of Justice regarding amendments to H.R. 2869, the proposed Commodity Futures Improvement Act, which were adopted by the Subcommittee on Conservation, Credit and Rural Development on July 26, 1989 and deleted by the full Committee on August 2, 1989. We understand that the amendments may be offered again when H.R. 2869 is considered on the floor of the House. These amendments, previously offered by Congressman Tallon, would enact criminal sanctions for an abuse arising from dual trading on futures exchanges. Under these amendments, "front running," in which a broker trades for his own account ahead of his customers, would be prohibited specifically and a knowing violation of that prohibition would be punishable as a felony.

As we previously indicated, the Department reviewed the amendments and determined that the existing antifraud provisions of the Commodity Exchange Act as well as the mail and wire fraud provisions of Title 18 provide ample statutory authority to proceed against front running offenses. Moreover, prosecution of front running offenses would not be facilitated by these amendments. Front running is in our opinion a violation of the Commodity Exchange Act and Title 18 and thus is adequately addressed by existing law. Accordingly, we urge the defeat of any effort to adopt these amendments when the measure is considered by the full House.

The Office of Management and Budget has advised this Department that there is no objection to the submission of this report from the standpoint of the Administration's program.

Sincerely,

Carol T. Crawford

Carol T. Crawford
Assistant Attorney General

Mr. ENGLISH. Mr. Coleman.

OPENING STATEMENT OF HON. E. THOMAS COLEMAN, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MISSOURI

Mr. COLEMAN. Mr. Chairman, today we begin the fourth reauthorization of the CFTC in its 15-year history. We do so at a very critical time in the Commission's history, the industry that it regulates, and the customers that that industry serves.

We are all aware of the innovations that have taken place in the futures industry in the last 10 years or so. Initiatives such as stock index futures and related instruments have changed the complexion of the futures industry. These and other initiatives have provided the industry with the tools it needs to conduct international commerce in today's global economy. Yet many of its daily business practices continue as they have for years in the face of these dramatic innovations the industry has experienced.

Therefore, I think it is appropriate for us to discuss publicly the questions raised when innovation and tradition meet and whether we have in place the safeguards necessary to protect the customer and the integrity of the markets. That is, I think, a very important part of this reauthorization deliberation which we are starting today.

With this in mind, I am somewhat surprised and disappointed that our witness list includes so few users, particularly banks and other financial institutions. Of course, I look forward to hearing from representatives of primary users, such as the National Grain Trade Council. I believe their testimony will be important and useful to this subcommittee. Even so, I would think that other segments of the futures markets would want to be heard.

Not long ago this subcommittee and many people in this country were concerned about stock index futures and the relationship between these markets and securities. For this reason, I think it is unfortunate that other regulators of financial markets who were invited to be here today—Securities and Exchange Commission, Federal Reserve, the President's Working Group—have all declined to appear before us.

Just one additional observation: We are all enormously grateful that the predicted economic collapse following the October 19 stock market drop did not occur. For this reason, some people have forgotten that important event. But I think this subcommittee has a duty to remember it and to help the Nation learn from it.

Mr. Chairman, as we turn our consideration to the Commodity Futures Improvements Act of 1989, I want to begin by stating my primary reason for supporting this bill. I believe the industry needs to make more progress in refining its audit trail system. You may recall that we considered this matter during the 1986 reauthorization when the Commission was seeking a new standard for trade recordation. At that time, the industry said that such a standard would drive business overseas. In fact, trade volume records indicate that that has not happened. In fact, I believe, an enhanced audit trail proved its worth following the October 1987, market break.

Accordingly, Mr. Chairman, while I understand the exchanges are making significant progress in their systems and commend them for it, I think it is time for Congress to establish some standards in the law dealing with audit trails. I believe the effort and expense of doing so will be more than offset in the future as domestic and global market users trade with the confidence that our futures markets are the fairest and the most efficient in the world.

As you know, under the bill before us, dual trading will be prohibited in certain markets under certain conditions until additional standards are met. We have heard from some traders that a ban on dual trading will harm, not protect customers. They state that the better traders will trade their own accounts, leaving the customer orders to inexperienced or inefficient traders. While this argument is plausible and although we have enabled the customer to name his own broker who may also be trading for his own account, I am willing in these hearings to accept additional testimony on this matter.

I would also note that pursuant to the wishes of this subcommittee and the committee chairman, this bill would discontinue the 4-year reauthorization cycle. We believe that a 2-year dollar-specific authorization will provide a better opportunity for us on this committee to perform our oversight responsibilities and be more responsive to Commission and market needs. I look forward to these hearings and the distinguished list of witnesses that we have in the next several days and look forward to continuing our work together, Mr. Chairman, as we mark up this bill hopefully by the end of this July. Thank you.

Mr. **English**. Thank you very much, Mr. Coleman. Mr. Morrison.

OPENING STATEMENT OF HON. SID MORRISON, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF WASHINGTON

Mr. **Morrison**. Thank you, Mr. Chairman. I chose not to cosponsor the measure before us, but I compliment our chairman and ranking minority member for at least heading us down a legislative trail and it be, of course, the subject of I think, some rather intense interest and experience that is starting this morning. I approach the subject with a very open mind. Futures trading is not vitally important in my area of agriculture, so I am going to listen to Neal Smith and others, our experts on the subject, because of the importance in their own area.

I agree with my colleague, Mr. Coleman, that audit trail is going to be, I believe, a significant part of our requirement. Toward the industry in general, let us make sure it works, that is our obligation. The subcommittee if it does work, do not fix it. If it does not, we will do it right.

Mr. **English**. Thank you very much. Mr. Harris.

Mr. **Harris**. Thank you, Mr. Chairman, and I would ask a unanimous consent that my statement be made part of the record.

Mr. **English**. Without objection.

[The opening statement of Mr. Harris follows:]

OPENING STATEMENT OF HON. CLAUDE HARRIS, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF ALABAMA

Thank you, Mr. Chairman, and good morning to all. I am glad that this hearing process has at last begun on the matter of CFTC Reauthorization, as I believe that many of our constituents are eager to see what positive affect this subcommittee will choose to make on an industry that has lately been under a very critical magnifying glass. It is certain that as the hearings proceed we will hear testimony that will speak to whether such critical scrutiny of the futures trading industry, and, of course, the CFTC, in particular, is justified or not.

For myself, I will reserve judgment and wait to draw conclusions until these hearings are concluded. However, no one can deny that public *perception* of the integrity of the commodity futures trading markets and their regulatory overseer, the CFTC, is of vital importance to our economy and, ultimately, the welfare of every American: The end buyers and users of these commodities.

Unquestionably some of the perceived integrity of the markets has been damaged and I feel that this inquiry into any legislative and regulatory shortcomings of the system will be a significant "first step" toward shoring up whatever damage may have been done to this necessary component of our free market system. Thank you.

Mr. **ENGLISH**. Ms. Long.

Ms. **LONG**. No statement, Mr. Chairman.

Mr. **ENGLISH**. Mr. Staggers.

Mr. **STAGGERS**. No, Mr. Chairman.

Mr. **ENGLISH**. Mr. Sarpalius, do you have any comments that you care to make?

Mr. **SARPALIUS**. No, Mr. Chairman.

Mr. **ENGLISH**. We are very delighted that our first witness today is a person who has long been interested in the subject of the futures industry and has been quite outspoken; one who has presented a number of views that I think people have from time to time come to adopt; and one of those who was there with the creation of the CFTC and participated in that overall effort; and one who is highly respected for his knowledge of the futures industry.

And, of course, I am speaking of our colleague, Congressman Neal Smith. Neal, we are delighted to have you here this morning and would be happy to receive your testimony.

STATEMENT OF HON. NEAL SMITH, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF IOWA

Mr. **SMITH**. Thank you very much, Mr. Chairman, for those comments. Mr. Chairman and members of the committee, I want to congratulate you for making the first serious attempt to find out what is wrong with the act and do something about it. In 15 years, there has been a lot of talk, but there really has not been any serious attempt to fill in the shortcomings and you are doing it. And I really want to congratulate you for that.

I will file my statement and make a few comments here.

Mr. **ENGLISH**. Without objection, your complete written testimony will be made a part of the record.

Mr. **SMITH**. You know, 15 years ago we held 6 months of hearings over at the Small Business Committee and then this committee held hearings after that. And it was clear at the time that we had about three alternatives. The first one was to ban futures all together. At that time we could have easily passed a bill from the Congress banning futures all together. The second option was to put it all under SEC and there was a lot of criticism about setting up a separate commission.

But I was one of those who thought that it was best to have a separate commission, especially in the case of commodities. Because I think commodities and financial instruments are somewhat different. And you will notice that the name of the commission is the Commodity Futures Trading Commission. It is not the financial futures trading commission. That was the primary reason for having a separate commission.

I think that the basic act that we passed in the House was pretty good, but by the time we got through conference at that time there were some shortcomings in the bill. And unfortunately each time we have tried to correct those, the industry has opposed corrections and so some of them are still there.

I have been somewhat disappointed in the CFTC. I say that frankly. It was 1 year before President Ford appointed any members. Some of the members have not been what we might expect them to be since that time, and in addition to that, they have not always had the resources they needed, especially the computerized resources. But on the other hand, it is not all their fault. Some of it Congress has to share because the basic law does have shortcomings in it that Congress has not corrected.

One of those, of course, is most visible at this time is the one involving dual trading, and each time we have reauthorized the bill, there have been excuses why you cannot ban dual trading. You know what they are: Liquidity is the old one and then you have not proven that there has been any fraud. Well, fraud and conspiracy is hard to prove. It takes a "sting" operation to do it. But we have a "sting" operation now, so there is not any question about it any more. That is no longer an excuse. It needs to be banned, and I think that until we get the computerized system, and I noted especially Congressman Coleman's remarks. This is the answer to it really.

We need a system, instead of this old horse and buggy deal they have in the pits. You need a system where you can go into Kansas City or Oklahoma City or Des Moines, Iowa, sit down in the broker's office, and you can look at the screen and you can know immediately whether or not you matched a trade. Immediately, not the next day. Immediately. That is the answer to it. If we do that, we do not need to argue about some of these things. Then we would know that the trade is honest. We would know that the industry is honest in that regard.

But until we get that, I would say that we ought to ban dual trading, maybe with one exception. And that one exception would be where you know or should know, when you walk into this office, that the contract you are dealing with is so small or the office you are dealing with, the exchange you are dealing with, is so small that obviously the person on the other side is going to shift the risk somewhere else to some other exchange or to some other contract. Except for that possible exception, I just think we ought to ban dual trading. If you ban dual trading, then you will put the encouragement that is necessary into this system where they will make the reforms that are necessary, and that will encourage computerized trading too.

Another visible problem is insider information, and it was banned at the Securities Exchange Commission 50 years ago. And the same activity for which they are prosecuting people in New York today would even be illegal if it is done on futures. And when a corporate officer or an employee knows that his employer is taking big positions—we are not talking about little positions, we are not talking about the country elevator operator—we are talking about reportable positions in the case of commodities. Whenever they know about some big positions they are going to be taking, and they take one for themselves in advance, in that instance they are really working against the interest of their employer. And in many cases, and I cannot say in most because I do not think it is so—in many cases employers have prohibited employees from doing that and officers of the company, but in some cases they have not. It just should not be permitted.

It is no longer just a matter of dealing with commodities now. We have a lot of financial contracts. And the SEC has been enforcing these with regard to financial commodities or financial contracts, but you know they are banned from doing things in New York, that they are not in Chicago. And so they can go on to the index futures and that is part of what happened in the catastrophe we just talked about. And so the two are related. We should ban insider trading too. It has spread to the financial futures now.

Another subject that I want to make mention that has not been mentioned much right now because we do not happen to have that kind of a movement ingrained that encourages thinking about it, but it is the reporting of export sales. I had bills in on all of these things, but one of the bills requires reports to be made to the CFTC instead of USDA. USDA cannot enforce reporting. They do not have any penalties to start with that amount to anything. They cannot force foreigners to report to them.

But a lot of these big sales are hedged on our futures market, as in the case of the one that was made on Canadian wheat a few years ago. All was hedged on our market. They not only hedged it, but they covered 60 million bushels more than they sold. And then sold off later the 60 million bushels and made a big profit on it. Our futures market, our farmers, our processors are the ones that are paying the bill. And we ought to make these reports come to the CFTC because the CFTC can immediately then enforce the reports to see whether or not they are speculating. They are in excess of the spec limits and they can suspend them from trading on CFTC and that is enough for a penalty. A small fine like they have at USDA is not enough to enforce reporting.

The American farmers have to give information, and they do freely, that is printed all over the world about our crops and the possibility of the size of the crop being bigger or smaller. And I do not think there is anything wrong with reporting to the CFTC either.

Now I have only highlighted three amendments that I suggested, and I know that you have examined numerous ones and I compliment you on the draft bill that you have. You have numerous things in there that are very important, and I still think that the business of shifting risks is still important to farmers and small businesses. And I want to do it by amending this law.

But I have to say I have reluctantly come to the conclusion that if we cannot get these minimum needed amendments this year, that protect against dual trading and insider trading and some of these other things, then I think that the time has come to consider seriously putting it under SEC where those are already prohibitions.

I know that you are approaching this very seriously and anything that I can do, it is not going to be much compared to what you can do, but whatever I can do, I want to help you do what you started out to do, and I want to compliment the committee for what you are doing.

[The prepared statement of Mr. Smith appears at the conclusion of the hearing.]

Mr. ENGLISH. Thank you very much, Neal. I appreciate it very much. As you know, the subcommittee is concerned over the question of whether or not the CFTC has had adequate resources to do its job. It is one thing to give an agency the responsibility; it is something else to provide the resources. And we are certainly pleased that the Appropriations Subcommittee included additional funding in the bill that is going to be on the floor today to address that.

If your two bills that you mentioned included any of the legislation to be adopted by the subcommittee, how much additional funding do you think that would require?

Mr. SMITH. I think that it would not require any additional funding because if you ban dual trading then they do not have as much of a problem enforcing the law as they have now. As it is now, it took several years to get the computer capacity, and I do not know that they have it adequate yet. But for several years they did not have computer capacity to follow these trades. On the Small Business Committee I had a study conducted. I had three people work 9 months to really nail down what had happened in one transaction or one series of transactions that happened over a 15-day period. Computer capacity, if it is adequate, ought to have nailed that down right away in 1 week.

So if you ban dual trading, then you stop some of the practices that are so difficult for them to follow and it will take less resources really. But they need all the resources they have even if you ban dual trading. They have a budget of about one-third of what the FCC does.

Mr. ENGLISH. How much of an impact do you think that lack of budget, that small amount, has on the ability to carry out this responsibility?

Mr. SMITH. It has some, however, I think that the shortcomings in the law are much more important than a small increase in the budget.

Mr. ENGLISH. The other feature, I suppose I should not be mixing the two, but of course the witness following you will be, is the CFTC. The essence of the CFTC testimony I think is that basically other than some of the changes that they are recommending that everything is fine. That there really are not any major changes that are necessary. Certainly beyond studies and whatever, but the general thrust of the testimony is that the CFTC has all the authority that they need and basically everything seems to be in pretty good shape as far as they are concerned.

Your testimony would seem to be somewhat at odds with that. How much of this comes down to resources? How much of it comes down to the changes in the law? How much of it comes down with regard to the attitude of the CFTC in what they see their role in their job?

Mr. SMITH. I think it is some of all of that. To start with, if they have the capacity, and they are using the capacity that is needed, then why did we have these scandals? Just on the face of it, it shows that there is something wrong. And even the one that happened in soybeans—what happened in soybeans last week should not occur. I mean, something is wrong when it is that late in the contract and they have that severe an adjustment. Then you had people dealing in the contract that have interests on both sides. There is something wrong with that.

So obviously some amendments are needed. And, of course, with regard to reporting sales, they do not even have the authority to require anybody to report sales, so it is very difficult for them in the case of the foreign customer or even a State trading company. A country that has its own State trading company is very difficult to know whether or not they indirectly are hedging or if they are speculating.

So there are shortcomings in the law. I think there is enough blame to go around for all three of those instances.

Mr. ENGLISH. Mr. Coleman.

Mr. COLEMAN. Neal, thank you for testifying and your positive comments about what Glenn and I have tried to do. Mr. Morrison calls the bill a starting vehicle, but it is one which we think has a lot of language which ought to be retained in the final product.

One of the things you mentioned and I think generally is perceived as a positive thing has been this undercover, as you say "sting" operation. And one of the things we put in the bill is to try to encourage the continuation of such potential undercover operations. And that may indeed require appropriations and additional expenditures in one form or another. As you know, to make an operation successful, you have to go through a lot of window dressing and so forth and so on to make sure that your undercover people are not found out.

So there may be reasons for the Commission and for us and for you to look at appropriations and to increase them to the extent that we are going to have this as a successful deterrent. I think that the industry recognizes, as well as the regulator and the Congress, that just the threat of having somebody on that floor all the time in an undercover capacity will keep some people from moving over the brink into an illegal situation. So I just want to remind you as we go forward together that we may have to have some increase for these types of activities, and we would obviously need your support. And I think that you are supportive of that type of effort, but it is probably going to cost some money.

Mr. SMITH. I agree with you, but I want to remind you of two things. One thing, of course, is the "sting" operation which was conducted by the Justice Department—I happen to Chair the subcommittee that handles their funding and I know it is going to cost a lot of money—that would not have been necessary if we had prohibited dual trading. They had to have a "sting" operation because they have to lean on fraud statutes and conspiracy statutes and that is extremely difficult to prove, and you almost have to have a "sting" operation in order to do it. If dual trading had been prohibited to start with, these abuses could have been stopped without going through all of that.

So I think that the amount of money needed to enforce this part of it would be even less. But I agree with you that we need to fund it.

Mr. ENGLISH. Mr. Morrison.

Mr. MORRISON. You obviously have a very firm exposition on the dual trading issue. However, you did allow that some smaller markets would probably be necessary to make the mark. A bill introduced before us includes the cutoff point of 7,000 contracts established in that size. Do you agree with that number?

Mr. SMITH. I do not really know what the number is, but I would say that I would use this, as you study it, as your basis. If I am dealing with a small exchange because I prefer to deal with them—perhaps I know them or they are close by—I ought to know that, if it is a big contract, that they probably do not have enough people there to match all the offers that need to be matched. That they are probably going to match it somewhere else or shift the risk. I think that is the basis, and I do not know the number of contracts that ought to be. Of course, where there are smaller numbers of contracts, there is more of a need to recognize that problem in other ways. But the answer to it, of course, is computerized trading.

Mr. MORRISON. So you agree with the tie-in that the bill provides for the number of size——

Mr. SMITH. I agree there is a difference between a small exchange out in Kansas City or some place and Chicago. I do not see any excuse for it in CBOT or in Merc, either one.

Mr. MORRISON. And yet the bill does provide for demonstrations of approved audit trails. I think that would have an impact on the trading issue.

Mr. SMITH. Well, it would, but the answer there again is computerized trading. We should not have to be fooling around with other trails. That is horse and buggy stuff. Guys getting down and yelling at one another. We have computers in this country. We claim we are a leader in computers. We ought to be able to go in—when I was chairing the Small Business Committee, I think it was GE—I do not want to use the wrong company, but I think that was who it was. We had them do a study to see whether or not they could set up computerized trading at that time. They said they could, but it would cost some more money to do it, but at that time they knew that the exchanges would not accept it anyway, so they would not spend the money.

For 10 years we have had the capacity to have computerized trading.

Mr. MORRISON. That time was how many years ago?

Mr. SMITH. About 10 years ago. That is the answer to a lot of these problems.

Mr. MORRISON. The same computer program, right? To place the appropriations process?

Mr. SMITH. It might. If it will, it sure will save us a lot of time.

Mr. ENGLISH. I am sure you are glad you did not carry that a step further and say Congress went on that.

Mr. SMITH. I thought of that too.

Mr. ENGLISH. Mr. Harris.

Mr. HARRIS. No questions.

Mr. ENGLISH. Ms. Long.

Ms. LONG. No questions.

Mr. ENGLISH. Mr. Staggers.

Mr. STAGGERS. I thank our colleague for testifying, but I have no questions.

Mr. ENGLISH. Mr. Tallon.

Mr. TALLON. Thank you, Mr. Chairman. Neal, thank you for your testimony. I just want to assure you that the committee and I and all of us are serious about eliminating the potential for abuse. In my mind, this means making the practice of trading ahead of your customer in these markets a criminal offense. It means making any sort of ban or penalty applicable to everybody, no matter how large or how small, no exceptions. And it means protecting people through greater surveillance and telemarketing restrictions. I really believe that we can and we must protect the integrity and the competitiveness of these markets.

Obviously you know a lot about futures trading and you have got great concerns about what I like to term "total market access." The more familiar term is dual trading. You seem to—I am trying to remember what you said—but I was thinking that you were talking about if the trades could be reconstructed immediately, rather than waiting until after the markets close or the next day that it would make any kind of a difference. I am not sure what you mean as far as not making any kind of a difference?

Mr. SMITH. Even then, there is trouble, if you have dual trading in the big contract because you have the possibility of traders working with one another. It is not always the trader that takes his own deck of cards and decides which one he is going to place in his own hand ahead of others, he can work with somebody else. Dual trading is just set up for fraud.

Mr. TALLON. Neal, do you get a lot of complaints from constituents about dual trading?

Mr. SMITH. Actually the complaints, and it is reflected in the use of the contracts, the complaints are they do not trust them. And as long as they do not, they are not going to use futures themselves. They are going to use them indirectly through elevators. Local elevators hardly use them any more. They have somebody else do it for them.

Mr. TALLON. So they are pretty big people that generally trade or do most of the business in futures markets?

Mr. SMITH. Right. I think that is true, but even then, they have their doubts and they know that it is right for abuse. They just know that it is right for abuse.

Mr. TALLON. Maybe you can help me, because obviously you know a lot about this. But the pretty big people who are generally trading in the futures markets, do they have to use someone who has total market access or who is a dual trader or do they have an option?

Mr. SMITH. Some of them have their own seat. They would not think of not having their own seat.

Mr. TALLON. But on all of these futures exchanges, are there people there who do not trade for themselves, who are not engaged in dual trading?

Mr. SMITH. Oh yes. Some of them do not trade for themselves. Not all of them are dual traders.

Mr. TALLON. These futures markets that are very important and in the interest of U.S. agribusiness and farmers and business general——

Mr. SMITH. The dollar value in the futures now is even more than the dollar value in securities. It is important.

Mr. TALLON. It is a very important market. But are not these markets all over the world? These futures markets?

Mr. SMITH. They are growing. Yes; there are some in other countries. I noticed whenever they had one of these great big sales over wheat, they come to our futures market to offset it, to shift the cost on to the American farmer and processor.

Mr. TALLON. But what kind of ban does the market, say in Japan or in Europe or Great Britain, what kind of ban do they have on what is called dual trading?

Mr. SMITH. I do not know exactly what ban each one of them has, but I bet you this, I bet the one in Japan will be computerized before long if it is not.

Mr. TALLON. I do not have any more questions, Mr. Chairman.

Mr. ENGLISH. Mr. Sarpalius.

Mr. SARPALIUS. No questions.

Mr. ENGLISH. Mr. Combest.

Mr. COMBEST. No questions.

Mr. ENGLISH. Mr. Nagle.

Mr. NAGLE. No questions.

Mr. ENGLISH. Thank you very much. We appreciate your testimony.

Mr. SMITH. I just want to make one other short statement. Several of you mentioned the resources and the amount of money that is needed. I do want to mention this. I was just reminded. You know some years ago, Chairman Johnson and Chairman Shad made an agreement as to dividing up the futures and then after that Congress incorporated into legislation that agreement—fixed it into place. I do not think the agreement was good to start with. I think it ought to be renegotiated. I am not advocating exactly what it ought to be in the agreement, but I think that another thing you might consider is releasing these two chairmen, so they can renegotiate a new agreement. Because if CFTC does not have the resources they need, they could do without some of those financial futures.

Mr. ENGLISH. Thank you very much, Neal, I appreciate it.

Our next witness is the Chairman of the Commodity Futures Trading Commission, Ms. Wendy Gramm, who is well known as far as this subcommittee is concerned. Wendy, I want to say how pleased we are to have you with us. If you would identify those that came with you, I see that you did not bring any of the other Commission members today; is that right?

STATEMENT OF WENDY L. GRAMM, CHAIRMAN, COMMODITY FUTURES TRADING COMMISSION, ACCOMPANIED BY ROBERT MACKAY, CHIEF OF STAFF; ANDREA CORCORAN, DIRECTOR, DIVISION OF TRADING AND MARKETS; DAVID KASS, DIRECTOR, CHICAGO REGIONAL OFFICE; DENNIS KLEJNA, DIRECTOR, DIVISION OF ENFORCEMENT; AND STEVEN MANASTER, DIRECTOR, DIVISION OF ECONOMIC ANALYSIS

Dr. **Gramm**. Thank you very much, sir. I did not bring Commission members today, but I did bring my technical staff. Here on my left is Robert Mackay. He is my Chief of Staff, who has been going over the legislation in some detail. Andrea Corcoran is to his left and is my Division Director for Trading and Markets. To my right is Dave Kass who is head of our Chicago regional office and has been the first person on the line with respect to the soybean markets. And then to his right is Dennis Klejna who is our Director of the Division of Enforcement and Steven Manaster, our Director for the Division of Economic Analysis.

I have brought them here, anticipating some questions of technical nature. I think that I can speak for the Commission with respect to the Commission's policy positions on the legislative proposals we have before us this morning.

Mr. **English**. Let me also say, before you get started, Dr. Gramm, that if you would care to submit written testimony and care to summarize, without objection, the complete written testimony will be made part of the record. And I may say that is for all of our other witnesses. If there is no objection, all written testimony will be made a part of the record.

Dr. **Gramm**. Thank you very much. I would like to do that, but I would like to take a few minutes to go through the Commission's position on the legislative proposals this morning, particularly since this is something that all of the Commission is very much interested in. I am pleased to be here to represent the Commissioners and to represent our reauthorization proposals, as well as to respond to the legislative proposals your committee has set forth in the Commodity Futures Improvements Act of 1989.

This authorization comes at a time when the Commission's aggressive enforcement program, as demonstrated by our participation in the undercover operation in Chicago and in the recent investigation in New York, has focused public, industry, and congressional attention on alleged abuses in commodity futures trading. Your subcommittee staff has just completed a thorough inquiry covering all markets and found the self-regulatory systems to be generally sound. The Commission also has conducted its own review of our oversight procedures and exchange trading practices. Now, this subcommittee is considering regulatory and legislative changes to further strengthen the Commission's ability to oversee futures markets.

The Commission supports the subcommittee's goals in this area. We believe that Congress has given us sufficient authority in the Commodity Exchange Act to fulfill our mandate. Thus, in our requests that we sent forward to you, we do not ask for major legislative changes at this time, although we are proposing some changes to enhance our regulatory program.

The Commission's legislative requests consist of five parts that deal with nationwide service of process, international law enforcement, civil monetary penalties, automatic suspension and trading prohibitions for failure to pay penalties, and registration of floor traders. I will review each of them very briefly.

The first proposal would amend the act to authorize nationwide service of process and special venue provisions in private legal actions brought under section 22 of the act. This proposal is a customer protection provision which would allow, for example, a customer who is defrauded by an out-of-State boiler room operation to sue in his or her home State rather than being required to go to court in the State where the boiler room actually had its principal place of business. Specifically, the proposal would allow private damage actions to be filed in the district where the defendant is found, transacts business, or where the transaction constituting the violation is found.

Our second legislative proposal is in the area of international law enforcement. As the process of internationalization of futures and financial markets continues, cooperative enforcement efforts with foreign futures authorities are becoming an increasingly important part of the Commission's enforcement responsibilities under the act. Therefore, we are proposing a new section be added to the act which would provide the Commission with explicit authority to conduct investigations on behalf of foreign futures authorities regarding violations of foreign laws, rules, or regulations relating to futures and options.

This legislative proposal would enhance our ability to cooperate with foreign futures authorities. There is worldwide interest in such cooperation, and other authorities are seeking this authority in their countries if they do not already have it.

Our third proposal amends section 6(d) of the act to eliminate the requirement that the Commission consider a wrongdoer's financial circumstances when assessing a civil monetary penalty. This amendment would give the Commission more flexibility in choosing appropriate monetary sanctions in the administrative law enforcement process.

Our fourth proposal also amends 6(d) to suspend automatically the wrongdoer's registration with the Commission and to prohibit him from trading on all exchanges if he or she fails to pay the penalty when due. This proposal would create incentives for wrongdoers to pay penalties promptly, and it is identical to the provision already in the Commodity Exchange Act mandating automatic suspension of registration and a prohibition of trading if a party fails to pay a reparation judgment.

Our fifth proposal involves the registration of floor traders. Unlike floor brokers, who trade for customers as well as for themselves, floor traders trade only for their own accounts. However, if floor traders collude with brokers in violation of the act or Commission regulations, they should be subject to the same regulatory sanctions. Requiring floor traders to register would subject them to statutory disqualification and fitness requirements like other registrants.

As I have said in earlier testimony, the Commission always stands ready to ask for more authority if we determine that we need more authority. We already have added three new legislative proposals to our legislative package since the beginning of January.

Now with respect to the legislative proposals that the subcommittee bill proposed, there are a number that are not addressed in our legislative package. We appreciate the fact that you have incorporated our legislative proposals in your package. While the Commission has not had the opportunity to fully consider and develop a position on every aspect of the proposed bill, I would like to respond today with the Commission's preliminary assessment of the major provisions.

Allow me to say at the outset, however, that the Commission shares the overall goals of this bill—to diminish the potential for trade practice abuse, strengthen the Commission's regulatory system, and maintain the integrity of futures and options markets, thereby increasing public confidence.

An improved audit trail is a priority and has been a long-held Commission goal. The Commission moved aggressively toward this goal in 1986 by developing the 1-minute trade timing requirement. More recently, the Commission asked each exchange to improve its system for reporting and using trade timing information to enhance its own trade practice surveillance program and requested a plan from each exchange for further improving their audit trail capabilities. Specifically, we have requested that each exchange review the verifiability of trade timing data, accuracy levels, and its procedures for assuring the accuracy of source records.

We are firmly committed to improving the audit trail in ways that are most effective in detecting trade practice abuses. We must be realistic, however, about the capabilities of these systems once their potential has been achieved. Audit trail systems are records analysis systems and neither these nor any other kind of record systems can detect all types of trade practice violations.

Accordingly, we believe that a careful analysis is necessary before decreasing the trade timing standard to 30 seconds or less. Changing the timing standard from the current 1-minute trade execution requirement to 30 seconds or less, for example, may not provide sufficient improvements in overall audit trail capability to justify what would be a significant increase in cost, particularly to the smaller exchanges.

Other audit trail improvements may be more effective in detecting and in preventing trade practice abuse. Such improvements could include, for example, collecting trading cards more frequently coupled with more frequent trade matching, granting compliance staff the authority to collect and copy trading cards on the floor, and limiting the entry of verbal orders by members on the floor. Similarly, we believe it may be a more effective use of other exchange resources to move toward on-line order routing, execution and trade reporting systems which would provide many other benefits in addition to the improved audit trails.

We appreciate the subcommittee's support of our efforts to achieve the audit trail improvements, and believe that our existing authority is sufficient to accomplish this important objective and we are actively pursuing that goal.

With respect to dual trading, we share the goals of the proposed legislation to rid the markets of abuses connected with the practice of dual trading. Indeed, the original purpose of the enhanced audit trail was to obtain records to identify and deter trading abuses related to dual trading and trading ahead of customers.

Earlier this year we began a study on dual trading to assess its role in fostering trading abuses and to determine whether any limitations on dual trading would adversely affect market liquidity. We expect our study to be completed in early October. We have concerns about the use of contract trading volume to trigger a dual trading prohibition. Using the average daily volume of 7,000 contracts as a trigger, as proposed under the bill, could have significantly different effects on different markets, depending on such factors as the size and characteristics of each market's floor trading population.

Accordingly, we believe that if specific restrictions on dual trading are to be set, they are more appropriately set by the Commission through its rulemaking authority. Through the rulemaking process we can apply a more flexible approach toward achieving the goal of eliminating dual trading abuses which we and the subcommittee share. The Commission would be able to evaluate on a market-by-market basis the efficacy of dual trading, taking into account the effects of any limitations on liquidity and the quality of the audit trails. In this regard though, we do welcome the elements of flexibility provided in the bill in implementing the dual trading prohibition.

With respect to undercover authority, the Commission has a strong record of vigorous law enforcement. And in the exercise of its own investigatory powers, the Commission has traditionally cooperated with criminal and other law enforcement agencies, both State and Federal. This has been most graphically demonstrated by the Commission's active assistance in the undercover operation in Chicago. We are pleased that the bill recognizes the importance of cooperative law enforcement with other agencies. And we also strongly support the subcommittee's intention to send a signal that these types of undercover activities may be undertaken at any time.

We agree that it is important for the Commission to define and identify broker associations for the purposes of surveillance and compliance programs. However, we believe it is important to develop data concerning trading activities of broker associations based upon industrywide definitions of such associations before attempting to determine what limits on intrabroker association trading might be appropriate. We are developing such information on broker associations through interviews of industry participants and the study of current exchange rules and practices. Our study should be completed by the end of August.

We believe that a rulemaking is more appropriate than setting a statutory limit because effective monitoring of broker association activities could require restrictions to be tailored to particular markets.

The Commission supports the provision that would bar individual members with significant disciplinary records from service on disciplinary or governing panels of exchanges and futures associations for a fixed period of time. As stated in response to an inquiry from the Senate Committee on Agriculture, Nutrition, and Forestry, we announced that we would promulgate proposed rules to address this concern by October 1989, even though some exchanges currently have rules prohibiting service on boards for certain periods of time.

We believe the bill gives us the flexibility to require self-regulatory organizations to establish what is a significant violation in a manner which will allow for sufficient diversity to reflect the different exchanges' rules and trading practices, and in the case of the National Futures Association, the different industry components represented by the members.

Currently, some exchanges have a two-tier disciplinary process in which one committee makes a determination whether charges should be issued and another committee hears the case regarding possible actions based on those charges. Exchanges also require members of a committee to recuse themselves from a matter if they have a potential conflict of interest.

We are concerned that requiring a majority of committee members to be from a different sector of exchange membership than the person appearing before the committee may diminish the technical expertise of the group enough to slow down the process and render a less effective and appropriate decision. We suggest that requirements regarding committee composition and the stages in disciplinary process should be addressed in a flexible manner in allowing for diversity across exchanges.

The bill would also require that 20 percent of exchange governing boards be composed of outside members, and it would require the Commission to provide guidelines defining who is an outside member. Most exchanges currently have rules which provide for some degree of board diversification, and the Commission has announced it will monitor governing board composition within the rule enforcement review process.

While a requirement for a minimum percentage of outside board members may add to the public confidence in the industry, the Commission believes that a quota system does not always achieve the desired results. In a June 1985 report, the Commission found that the performance of public directors sometimes was limited by the directors' absenteeism, failure to prepare sufficiently, and failure to provide expert assistance. These factors must also be recognized and considered before further restrictions concerning board membership become part of the statute or the Commission's rules.

The Commodity Futures Improvements Act of 1989 would require the Commission to develop procedures to assure that nonhedging, first-time futures and options customers cannot trade on newly opened accounts until 3 days after signing the account opening agreement. We believe this amendment is not necessary since under our current rules, no futures or commodity options transactions can occur legally until the first-time customer receives a certified written risk disclosure statement, acknowledges in writing that he or she has received and understood the disclosure statement, and the broker has in hand the signed statement, which he or she must retain.

With respect to ethics, the Commission supports the idea that registrants be educated in the purpose and functions of futures and options markets and in the rules and regulations which they must observe to legally trade in these markets. Furthermore, industry participants must understand the significant sanctions they face if they abuse the markets and violate the law.

The Commodity Futures Improvements Act of 1989 proposes several amendments to the registration disqualifications. These proposals must be carefully evaluated for consistency with the statutory disqualification scheme Congress enacted in 1982. The current proposal raises concerns that it is not fully consistent with the logic that underlies the 1982 amendments, and we are also concerned about any amendment requiring the Commission to recognize the authority of other regulatory bodies to create or apply exceptions to the disqualifications listed in section 8a.

This is the fourth reauthorization the Commodity Futures Trading Commission has faced since the Commission was created in 1974. During these 15 years, the futures industry has enjoyed unprecedented growth. The Commission has developed into a mature and able regulator. We support your proposal to make the CFTC a permanent agency. The misconception that the agency may somehow disappear is one that may erode public confidence and should be put to rest once and for all. Permanent reauthorization is consistent with regular and active congressional oversight of the agency which the Commission has always supported.

The bill would also authorize $40 million for fiscal year 1990 and $44.5 million for fiscal year 1991. The increase for fiscal year 1991 would be sufficient for over 80 additional staff members. I am submitting for the record a brief outline of the progress we have made in dealing with the 1986 reauthorization issues and amendments.

Thank you, and I would be pleased to answer any questions you might have.

[The prepared statement of Dr. Gramm appears at the conclusion of the hearing.]

Mr. ENGLISH. Thank you very much, Dr. Gramm. I appreciate your testimony. Without running the risk of oversimplification, as I made the point to Congressman Smith earlier I believe to kind of sum up what your testimony is, I think on page 2 of your written testimony. The first full paragraph you make the comment:

> While the Commission supports the subcommittee's goals in this area, we believe that Congress has given us sufficient authority in the Commodity Exchange Act to fulfill our mandate to oversee the markets. Which I think we just basically say no significant change is supported by the CFTC.

I think you are missing the point of this legislation. The point of the legislation is to try to lift the standards substantially higher than what they are today. And as we said the overall thrust of this effort is to try to make certain that the integrity of the American's futures industry is protected and to make certain that the people who deal on those markets, customers, have confidence in them. And that we want to make sure that as far as our overall ability to detect any wrongdoing that that is raised to the highest possible standards. And at least through our inquiry, we found that what we have today does not meet that definition.

Let me also say too, I was struck by the fact, just out of the Wall Street Journal yesterday—I do not want to give one paper an endorsement, but in this particular case, they had a couple of references in here. We have a grain commodity adviser up in South

Dakota who is quoted as saying that what has taken place last week, as far as soybeans are concerned. It makes us look like crooks is what he says and then he goes on to say that we are going to lose business over time. He is a trader that went out and set up business a couple of years ago. He has about 80 farmers he has had to go to now and ask for more money, and he said that many of these farmers, that is the first time that they had ever used the markets. And he said now they are angry that they ever tried it.

They got another commodity brokage firm, a representative over there, president of this firm over in Cedar Falls, Iowa. He makes a statement that people are losing confidence. Not only did the FBI investigation taint the image of the board, but now we have an intervention that, for the casual observer it does not make much sense.

We have a representative who deals with people overseas. It says here a senior officer of one of the international grain trading firms said that the firm's foreign clients are incensed. "We are getting ready for bitter reactions from overseas." All of that does not really encourage me at least to go along with the business as usual type approach as far as the futures industry is concerned, and that is what we are talking about as far as standards. That is the message that we got and I think that the fact that U.S. attorney's investigation which became known to us back in January. All of this seems to underscore that.

With regard to what has happened in Chicago in the last week with regard to the board of trade in soybeans, what role did the CFTC play in that decision process?

Dr. GRAMM. Mr. Chairman, if you do not mind, I do think that the soybean situation is one where there has been a lot of question, a lot of comments, and while I do not necessarily believe in the reports of some commentors to gauge public confidence in these markets, I would like to go through and review very briefly with you what has happened in the soybean market.

Mr. ENGLISH. If you could keep it brief. We are limited to 5 minutes here, and I have a number of other questions—5 minutes for me. In fact, my 5 minutes just expired, Dr. Gramm. So we will allow you to go through the procedure and then I will let Mr. Coleman ask you all the tough questions about that procedure.

Dr. GRAMM. Basically, as you all know, the board of directors of the Chicago Board of Trade on Tuesday adopted a resolution finding that immediate action was necessary due to an emergency that would threaten the fair and orderly trading and liquidation of the July 1989 soybean contract. You should know that the CFTC as well as the exchanges have a responsibility to ensure the orderly liquidation of all expiring contracts.

As you know, we monitor routinely all of our markets. Since last summer we have had concerns over various grains and have paid particular attention to these markets this past spring, particularly the old crop markets. I should point out just a few facts here. On July 10, the open interest in the July contract stood at 40.3 million bushels which is larger than any July expiration in at least the last 6 years. There was significant concentration of firms holding those positions.

In addition, the supply of soybeans in a deliverable position was 12.7 million bushels, substantially less than the open interest of 40.3 million bushels. A large portion of these soybeans did not appear to be available for delivery on this contract, and the ownership of the deliverable supply was concentrated as well. So, little additional supply was expected to be placed in a deliverable position. Now the price relationships that we monitor——

Mr. ENGLISH. The point I just wanted to ask you, Dr. Gramm, I think most of this has been in the media. I just want to know what role the CFTC played. What involvement did the CFTC have in this action?

Dr. GRAMM. The CFTC has monitored these markets for several months. We have had some concerns and thereby monitored some of the liquidations in the spring, particularly the May liquidation of the old crop soybeans. As is usual in cases like this, we will have discussions with all of the major traders in the market, as well as other participants in the market to see whether or not there will be an orderly liquidation of the contract.

Mr. ENGLISH. The question was: Did you consult with, advise, participate with, in any way in the decision that was made?

Dr. GRAMM. We knew of their concern. We had discussions with the exchange. We have had discussions with the exchange on a daily basis.

Mr. ENGLISH. Did you make any recommendations?

Dr. GRAMM. We did not make recommendations, but we did discuss some alternatives. We were in daily contact, not only at the staff level, but at my level as well. We were not only in this expiration, but in earlier expirations as well. Whenever we have had concerns over orderly liquidations, this is the normal procedure that staff follows as well as, if it need be, at the Commission level. We have regular surveillance meetings of the Commission and all Commissioners were briefed on what was happening in these markets. Again, we stood ready and stand ready to act in any situation where we feel there is a problem that requires our attention.

Mr. ENGLISH. Just one question. Did you support? Did you oppose? Did you comment on this decision before it was made?

Dr. GRAMM. I was informed about the decision. In terms of supporting or not supporting it, one of the things you should know is that, as part of the self-regulatory process, we expect the exchanges to carry out their responsibility for orderly liquidation. Of course, we review all emergency actions after the fact to determine whether or not their actions were arbitrary and capricious. We also determine whether or not the exchange followed procedures that would prevent unauthorized disclosure or misuse of information or conflict of interest problems.

Mr. ENGLISH. But not whether they were good or bad decisions?

Dr. GRAMM. Basically we do that as well, and that is part of the post-review, the post-emergency action review that we do.

Mr. ENGLISH. Mr. Coleman.

Mr. COLEMAN. Do you have the authority now under current law to intervene with the exchanges? Can your role be more proactive than reactive, and not done on a review basis?

Dr. GRAMM. Yes, the Commission has emergency authority under section 8a(9). We can direct the contract market to take such action as is in the Commission's judgment necessary to maintain or restore orderly trading in, or liquidation of, any futures contract, and we have done so in the past.

Mr. **Coleman**. But you have decided not to do it in the current situation, the soybean market?

Dr. **Gramm**. Well, let us say that, as of this point in time, the market is still open and the CBT has taken some action. We are continuing to monitor the market and should additional action be required, it would be taken.

Mr. **Coleman**. But at this point, it takes on a different character than if you had utilized your emergency powers in the beginning as opposed to the exchange using its self-regulatory authorities.

Dr. **Gramm**. I think that the notion of having the exchange be very much responsible for orderly trading is that they have not only the responsibility, but also the incentive to make sure that that action is sufficient to deal with the problem. And as you can imagine, whenever you take an emergency action, there will be people on either side.

Mr. **Coleman**. Winners and losers. And the Commission has decided not to act in this case, and yet thousands of farmers are being impacted on a daily basis by a roller coaster ride of prices which are a direct result of trying to unravel what has occurred. And there may be some who would fault the Commission for failure to preempt this process so that protection of the farmer, the producer, and certainly other users of the commodity would have had more protection. That is what we are asking you to comment on.

Dr. **Gramm**. Are you suggesting the Commission should have acted earlier or acted later? I mean the issue is that there are always a number of options that face an exchange or the Commission. We have used a number of them, but that again——

Mr. **Coleman**. I guess we are asking at what point in your internal decisionmaking process bells go off, red lights flash, and somebody is going over the brink, and you determine that your emergency powers ought to be used to protect the public or the integrity of the markets?

Dr. **Gramm**. Basically, some of the factors that we consider include the amount of open interest as compared to the deliverable supply, the concentration of that deliverable supply, and the price relationship between the expiring contract, the nearby contract and the cash price. There was a very large inverse relationship between the July and August soybean contracts. There are a number of things that we have done and continue to do in any market where there may be some concerns about orderly trading. We have undertaken a number of these actions and will continue to monitor these markets.

Mr. **Coleman**. But in answer to Mr. English's question, you did not even make a recommendation to the exchange.

Dr. **Gramm**. Again, this is a market that is still open—there is still trading going on; and it is a situation where we have discussed with the exchange a number of alternatives they have raised, and our concerns about those alternatives. As we do in all liquidations, we have had constant discussions with large traders and other market participants.

But again, let me point out that the action by the CBT and the resulting behavior in the market made it less necessary for the Commission to take more drastic action in the short run.

Mr. COLEMAN. That goes somewhat to the heart of what reauthorization is all about to the extent that Mr. Smith and others may feel that self-regulation is not adequately protecting customers and so forth. And, I guess when you have a situation that develops like this one, we need to know that if self-regulation is not working, we got a backup. You are the backup, and in some cases you have to come out of the shadows, so to speak, and move into the forefront and become the protector. You are the final protector. You are the public agency.

Dr. GRAMM. I think at this point though your question, and again this is a market that is open, has behind it a certain judgment as to the outcome. I would say that in the market surveillance area there are a number of steps that we take, have taken and will take in order to ensure orderly liquidation in the markets. Bear in mind that, in the 4 trading days since the emergency action was taken, the congestion that was occurring seems to have been reduced. The open interest has declined, for example, by more than 20 million bushels, and the July futures premium to the August future has declined from 40 cents to about 15 cents.

Mr. COLEMAN. Dr. Gramm, thank you, and let me ask you one other question. When did you and the exchange get down to some real nitty-gritty discussions about this. Tuesday was their date of announcement, I believe. When was the pressure building up or when did the heat get intense enough that the Commission and the exchange knew they were going to have to do something?

Dr. GRAMM. We have been talking to the exchange about the expiration of July futures since May.

Mr. COLEMAN. But on a real intense basis, when was it building up? Was it 1 week before Tuesday? Was it the day before Tuesday? Can you give us an idea?

Dr. GRAMM. It was the week before Tuesday, during that week, but at the staff level. Let me have Dave Kass address the monitoring that typically goes on in a liquidation month when you have these kinds of concerns.

Mr. COLEMAN. The exchange by then knew that something was going to be done, either they were going to have to do it or you conceivably could have done it?

Dr. GRAMM. I would not say that at this point in time. We were reviewing a host of possible actions. Whenever there are concerns that arise toward liquidation, our staff, as well as exchange staff, discuss these concerns with the traders to see what their plans are for ensuring an orderly liquidation. I should point out that it is the responsibility of all participants in the markets to ensure orderly liquidation. These markets, in fact, are primarily for hedging purposes and price discovery, rather than for delivery.

Mr. COLEMAN. And you predicated your action or inaction on the basis of their fulfilling their responsibility?

Dr. GRAMM. All of our action takes into account what has happened in the market, including the action that they take. And therefore will have an effect on our decision to take further action or not. It is also determined by what happens in the marketplace.

Mr. COLEMAN. I guess what is frustrating to members on this panel is that considering these actions or inactions in considering and looking back, every day the market is up or it is down. It has been down. Now it comes up a little bit and plunges again and farmers decisions and their returns are being affected. You almost, I do not say cavalierly, but you are talking about looking at this on some sort of academic context, and it is not. It is a real world. People are losing their shirts on the basis of what is happening out there, perhaps their farms, and as a result any look back is not going to protect their interest to that extent.

Dr. GRAMM. What I want to make clear is that the Commission has been monitoring these markets to ensure an orderly liquidation. Again, there are a number of reasons——

Mr. COLEMAN. I just want to impress on you and the Commission that they are real farmers, real producers, real users, real consumers, and that a report that lands on our desk 6 months from now about this is going to be something they can burn in the fireplace over the winter, because it is not going to affect their real life to that extent when you have a market that people out here are losing money on.

I will stop here. I have another series of questions, not on the soybean issue, but on audit trails. Mr. Chairman, I assume we are going to go around again.

Mr. ENGLISH. Yes, I think we will have at least one more round. I think we are going to have a lot of questions on this issue. Mr. Harris.

Mr. HARRIS. Thank you, Mr. Chairman. Dr. Gramm, in this I guess this is probably using the proper term, but in reading your statement on page 2, you say, "Thus we are not asking for major legislative changes at this time." That sounds like a hedge to me. I wonder why you would have that qualifier in there. Is there something out there that maybe we need to know about that you are reserving judgment that maybe you would come in and say, now at this time we do need to measure legislative——

Dr. GRAMM. I am glad you asked that question because I think it is a very good one. What we have said is that at this time we are not asking for more than what we have requested here. But as more information unfolds, we may determine that we may need more legislative authority to address, for example, information that we may receive as a result of any indictments resulting from the undercover investigation. That there may be other authority. We may be getting more information from those sources. Should we determine that we might need more authority—to aid in orderly liquidations or whatever issue may come up—we stand ready to make those changes.

I think it is important to say that while some people have talked about scandals in these markets, a point that I would like to make here is that we do have information about the existence of the undercover operation that we are participating in, and it may well provide some very useful information on how we may improve our systems and improve the ability of these exchanges and of traders to perform and abide by the rules.

With respect to the market emergency and the order with soybeans, we will be reviewing the emergency action as we do all emergency actions taken by exchanges.

Mr. **Harris**. Well, you will have to, I am sure, understand that folks are getting pretty sensitive, after at least going through in the House, the problem in the legislation concerning the savings and loan. Now every time we pick up a paper about HUD that maybe instead of hands off that occasionally we need some hands on. This article that was in the Washington Post back in January of this year in quoting James Stone who was Chairman during the Carter administration. He said, "The Congress and the Federal regulators have repeatedly been warned of the possibility of the dishonest traders. The escape protection have done nothing about it." Do you agree with that?

Dr. **Gramm**. On the contrary. I think that with what we have done, we have had significant improvement over the past few years in the ability to detect trading abuses. The whole audit trail was developed in order to better detect trade practice type abuses. The fact that we have been involved in an undercover operation may provide more information about those kinds of things; trading abuses that may be occurring on the floor and how to better detect them to make the markets even better than they have been in the past.

I would disagree that we have a hands-off approach here. We have very much a hands-on approach. The Commodity Exchange Act's emergency authority gives us the ability to monitor the markets and to really regulate in a way that goes beyond, for example, just disclosing and letting anybody do anything. We monitor quite vigorously here, and I would point out that comment was made early on. What is illegal for one person to do by oneself is also illegal for two people or three people to do. In other words, using an accommodating broker to cheat a customer is still fraud and it is illegal under the Commodity Exchange Act. And as a matter of fact, in the trade practice cases, part of the challenge is to determine whether an accommodating broker has been used to defraud a customer.

Mr. **Harris**. Mr. Chairman, my time is up. I have other questions for later.

Mr. **English**. Ms. Long.

Ms. **Long**. Thank you, Mr. Chairman. Dr. Gramm, I think that part of the solution or a big part of the solution in problems in commodities trading and futures trading can be dealt with fairly efficiently with computerization. And it seems to me that the computerization that we are talking about is really fairly simple. The algorithms cannot be that complex. The only difficulty or the only real challenge is in the volume of data input.

I guess my question to you is why are we not seeing computerization used in a more widespread way in the commodity exchanges?

Dr. **Gramm**. That is also a very good question. We have seen a tremendous amount of computerization of different aspects of trading ranging from records keeping and audit trail, to the various surveillance programs. The Commission also has improved its computer capabilities to monitor the markets. So that is one aspect of it.

With respect to, I think, the more visible aspect of what is going on in the pits, you should know that we have just recently approsal, for example, in CBT where that role of proposals—there are new screen trading system that is totally computerized. The system is in the testing phase right now. Basically, I think the question of whether computerization will take over the markets is something that market users will probably help determine over the long run.

And from my perspective, we at the Commission do review very carefully a whole host of issues related to the GLOBEX-type proposals, for example, in CBT where that role of proposals—there are a number of screen trading proposals that have been made by exchanges. What the impact will be, whether or not they will replace the pits, again, will be determined by the users. The pits have been useful to many users for many years, so only time will tell what ultimately will happen, but there has been a fair amount of computerization in the other aspects of exchange operations, as well as Commission oversight.

Ms. LONG. It seems that in so many industries that computer technology has been used and we are sort of on the cutting edge in the United States. But in this particular industry it seems to me that we are really using some very archaic means of operation, and there are probably a number of reasons for that. I would say that computer producers are probably not as anxious to develop systems and programs and hardware and software for this particular industry because it is fairly limited.

But it also seems to me that there has to be some uniform or consistencies in what is needed as you go from one exchange to the other. And what we have tended to do in the past is set performance standards for the exchanges and we have said you must meet these standards, but it seems to me that the CFTC could actually play a more active role in helping with or assisting with the development of computer technology that will be usable by all of the exchanges.

I really think we need an accurate recording of the time orders are placed, as well as the buys and so forth. I really think that that is a key to solving some of the abuses in futures trading.

And I think and I guess what I am suggesting to you and asking you to comment on is why cannot the CFTC play an active role in providing assistance in developing the computer technology to the exchanges?

Dr. GRAMM. I think, first of all, that a view the Commission supports and would like to see is performance standards that allow the exchanges to compete with each other and to see what works. Even with audit trail, we did not tell them how to do their audit trail. We monitor the output rather than the input. It is a view of the Commission that the competition would generate the best results in terms of what is useful to the customer and ultimately to the user. And then the user will determine what best suits their needs. There are a lot of different markets, some of which are very large, some of which are very small.

You should know that there have been some totally computerized screen trading systems that have been proposed in the past and have failed. In fact, the GLOBEX-type trading proposals are really at the cutting edge of innovation in the futures area around the world. I think that we do "provide assistance" when we review the exchange proposals just by the hard questions that we ask. How are you going to meet certain requirements? What is going to happen under certain circumstances? What are you going to do about this computer's security? What is going to happen if you have two orders? How will the orders—how will the prices be set? What will be the sequence in which the orders are taken.

With respect to Government agency determining which system is best and therefore imposing its judgment on all the exchanges and saying this is what you should do, well that is something that the Commission has stayed away from. That is something that Government is typically not really the best equipped to do. The market users and the exchanges in competing for business will do that. We are there to make sure that they carry out all the responsibilities that they have under the Commodity Exchange Act, but not tell them that they have to do it by having a specific way of doing business. That will be determined by competition.

Ms. LONG. But as the regulating agency, you should be state-of-the-art in terms of development in the area of computer technology and how it can be used. And without mandating a certain system or certain software or certain process, you ought to be able to do more than ask questions regarding how they are operating.

Dr. GRAMM. Oh, absolutely. In our review, we do review these systems in great detail. And we are monitoring, for example, from the earliest stages right through to the testing phases to ensure that these systems work as they are supposed to. Also, more importantly, are the systems in accord with the responsibilities of the exchanges and our rules and regulations. And, accordingly, given the computerization that is occurring and the demands because of the new kinds of systems, we are enhancing and boosting our computer capability.

Ms. LONG. I guess my time is up, Mr. Chairman, but it just seems inconsistent to me that we have computers for over 40 years and the CFTC has been in existence for 15 years, and we are struggling with problems in monitoring and regulation that really should be way behind us in terms of technology.

Mr. ENGLISH. Mr. Tallon.

Mr. TALLON. Mr. Chairman, thank you.

Dr. Gramm, thank you for your testimony. If you could, please help me with my time, which is limited. If it is sufficient to give a yes or no answer to this question, that is all I really want to know because I still do not know if I have it clear in my mind.

Did the Commission at any time conclude that there was a threat to an orderly liquidation of the July soybean futures contract at the Chicago Board of Trade prior to Tuesday?

Dr. GRAMM. Yes.

Mr. TALLON. Thank you.

When did the Commission reach this conclusion, and what information did you rely upon in making this independent market judgment?

Dr. GRAMM. It was a developing situation. We had been concerned, really, since the prior expiration. We had been concerned about July beans just as soon as the May liquidation was over. So it has been a surveillance concern of the Commission for months.

Mr. **Tallon**. But when did you conclude that there was a threat to orderly liquidation of the July contract?

Dr. **Gramm**. I think it is difficult to put an exact time on that.

Mr. **Tallon**. Dr. Gramm, what steps would the Commission recommend in the future to prevent any possible threat to an orderly liquidation in this market?

Dr. **Gramm**. Well, I think that what we will be doing is reviewing—in our review of the emergency action, we will again give further thought about whether or not there might be other changes that would alleviate some of the liquidation or congestion concerns that have been raised in this expiration.

Mr. **Tallon**. Dr. Gramm, as I have stated earlier, in my mind the practice of trading ahead of your customer should be made a criminal offense. As far as the CFTC is concerned, would you have any comment on that?

Dr. **Gramm**. Trading ahead of a customer, because it involves abuse of a customer interest, is fraud and, therefore, a criminal offense under the Commodity Exchange Act.

Mr. **Tallon**. Has the CFTC found that dual trading abuses are particularly difficult for exchanges to detect?

Dr. **Gramm**. With the onset of the audit trail, which is the sequencing of trades, it made dual trading abuses easier to detect and easier to bring cases like that. I would also say that it probably deterred dual trading abuses because of the record that would be available.

Mr. **Tallon**. Would you say that in the last several years there has been a tremendous amount of developing on the part of the exchanges improved audit trails that has been a focus of the exchanges?

Dr. **Gramm**. Well, absolutely. Before 1986, and our 1-minute time standard, the requirement was a 30-minute time standard. So in just a few years, we have gone from a 30-minute bracket to being able to sequence trades in 1-minute increments.

Mr. **Tallon**. Dr. Gramm, when you said that it is easier to detect any trading ahead, what about in markets with daily volumes above 7,000 contracts?

Dr. **Gramm**. Pardon me?

Mr. **Tallon**. It is also easier in markets that have in excess of 7,000 contracts traded daily?

Dr. **Gramm**. I think that the existence of the 1-minute time standard and the audit trail vastly improved the ability of the Commission to bring and detect dual trading abuses, or trading-ahead abuses across all markets.

Mr. **Tallon**. Well, I have grave concerns about the restrictions in the current legislation that is before the committee. But in my mind, if you are going to restrict dual trading, it needs to be—if there is a problem, and I do not know and I will ask you some questions later on. But if there is a problem, let us restrict it. I mean, let us do away with it.

Anyway, I see my time is up, but maybe we can get back to that again.

Mr. **English**. Mr. Combest.

Mr. **Combest**. Thank you, Mr. Chairman.

Dr. Gramm, does the Commodity Futures Trading Commission have the authority today to ban dual trading?

Dr. GRAMM. Yes, we do.

Mr. COMBEST. You have got a study under way that is going to be out in October or September?

Dr. GRAMM. Yes.

Mr. COMBEST. Would you feel that any activities now to legislatively ban dual trading as proposed in this bill would be premature?

Dr. GRAMM. I do think so.

Mr. COMBEST. It appears that dual trading is sort of the recipient of a lot of the attention which has been given to the problem in Chicago which was uncovered due to the sting operation. Does that solve the problem if dual trading is banned?

Dr. GRAMM. Not necessarily. And I stress again that we may get more information from the results of the undercover investigation. But I think the point should be made—and Congressman Tallon, I think, to your question as well—is that the Commission would rather focus on the issue of eliminating abuse, of all sorts of customer abuse, and that may include the use of an accommodating broker, for example, which would be more than just dual trading abuse.

Mr. COMBEST. So that alone really would not—you do think that there are other ways to get at eliminating the problem of customer abuse that should be delved into, rather than simply a ban on dual trading and an increase in the audit trail, timing of the audit trail?

Dr. GRAMM. We are taking a broad-based approach, and part of that approach is to look at dual trading once again, to get again some empirical information about both the benefits as well as the costs of dual trading and the concerns there. And that is part of it, but, again, the Commission works hard to eliminate customer abuse wherever it occurs.

Mr. COMBEST. I think the Commission comes into somewhat of a unique position in that, given the concerns of a couple years ago in the October market readjustment, the Commodity Futures Trading Commission I think was given a pretty good pat on the back for the work that it did in following the volatility of that day. There have been a number of questions asked today about your role in the current ongoing soybean situation, recognizing that people's futures—no pun intended—but their future and their farms and everything else depend upon maybe what it is you do. But you are not in the business of regulating markets. You are not there to stop market movement. You are there to watch what is happening and to determine whether or not what is happening is legal or illegal, basically, more than to determine what the market is going to be on any given day.

Dr. GRAMM. Oh, in terms of directing what the price ought to be, definitely so. But we do monitor the markets to ensure orderly liquidations.

Mr. COMBEST. Right. And I just want us to be clear that there is not an indication given that you should be there just because somebody has taken a bath. We do not particularly like that, but it does not mean that you are supposed to step in just because somebody has taken a bath.

Dr. GRAMM. That is right. The primary responsibility is to ensure that the prices indicated by these markets represent the underlying supply and demand rather than anything artificial.

Mr. COMBEST. You said that October is when the report on dual trading that you have——

Dr. GRAMM. Yes.

Mr. COMBEST. Thank you, Dr. Gramm. Thank you, Mr. Chairman.

Mr. ENGLISH. Mr. Grandy.

Mr. GRANDY. Thank you, Mr. Chairman.

Dr. Gramm, I want to address the more immediate concern, and I say that because I was just home this week, and obviously the talk at the grain elevators is in regard to the Ferruzzi matter, not our pending reauthorization of the CFTC. And I guess the questions I want to ask you begin with: In your mind, is there a significant difference between insider trading as it is defined and prohibited by the SEC, and insider trading as it is defined, if it is defined, by the CFTC?

In other words, what is your definition of insider trading?

Dr. GRAMM. Basically, the disclosure of material nonpublic information is the notion of inside information. But in the futures markets, it has a little different cast.

First of all, in the securities markets, you are talking about inside information as it relates to a particular stock.

Mr. GRANDY. Right.

Dr. GRAMM. All right, a particular company, information about a company, issueswise. In the futures markets, you do not have that same notion specifically. But you do also have to understand that in the futures market hedging, just hedging, implies that you are doing something with some knowledge about what is involved. For example, if you are a farmer, the crop you are bringing to market, the amount of soybeans you may be bringing to market in the fall. So that is information, and obviously that kind of information is just a regular business of the futures markets. But we——

Mr. GRANDY. OK, but let me just interrupt you there for a moment, because this does relate to, at least in the minds of a lot of my producers, what happened on the Board of Trade this week. The fact that the July contracts were settled in the minds of a lot of producers, prematurely forcing a 39-cent drop in the price of beans on Thursday or Friday, was it inside information that occasioned that settlement? There is nothing that I have been able to find that is illegal about what happened, but to a lot of my producers, it is considered to be unethical, the perception being that some of Ferruzzi's major competitors probably influenced the Board of Trade to force those settlements, and thereby drop the bean prices so the Ferruzzi competitors could acquire beans.

Is that insider information?

Dr. GRAMM. Let me mention the other issues related to insider trading that would be considered unlawful in our markets. For example, Commission regulations make it unlawful for employees of self-regulatory organizations to disclose or use material nonpublic information. And we require the exchanges to have regulations that would prevent their board members from using or disclosing material nonpublic information that they obtained while discharging their duties as board members. So, indeed, if a situation like that had occurred, that would be violating the rules of the exchange. Or if there were employees involved, that would be violating the rules that the Commission had set forth. That, again—go ahead.

Mr. GRANDY. I was just going to say, our colleague, Mr. Smith, Neal Smith of Iowa, testified. And I do not know if you heard his statement or not.

Dr. GRAMM. Yes.

Mr. GRANDY. But he was talking about insider trading, and he says this:

> Corporate officers aware of a pending announcement of a large increased sale or purchase of a particular commodity or position in the futures market could use that information to trade in futures for his own account before the information is made public.

Is that disallowed?

Dr. GRAMM. That would be disallowed. Did he say of a large—now, if it is a private company or if it is the exchange——

Mr. GRANDY. No. A private company I am talking about.

Dr. GRAMM. OK. For a private company, if the individual used information and had responsibility for the trading activity of that company in the futures market.

Mr. GRANDY. But if he did not, he could use that information?

Dr. GRAMM. If he did not and if the company did not have rules to prevent that.

Mr. GRANDY. All right. Because that was his next statement. He says:

> Since it is contrary to the interest of the company they work for, some companies now prohibit their employees or officers from using inside information this way, but some do not.

The purpose, I suppose, of that testimony is that Mr. Smith has a bill and has had a bill for around 7 years to basically disallow that practice. Do you think that is unwise to enforce that among private companies?

Dr. GRAMM. I guess I would reiterate the questions that I raised to the Congressman when I spoke to him about this bill. That is, wouldn't the companies themselves have the incentive to set those ethical guidelines for their own employees if they felt the need to? Second, is that a problem? Has there been abuse of that trust by employees? Those are the two basic questions. I think I would like to have the answers to those questions before we say that it would be a good idea; it might not be a widespread problem.

Mr. GRANDY. But based on what we have just been trying to define as insider trading, and in your position as the Chairman, what happened between Ferruzzi and the Board of Trade and other players was not an example of insider trading that occasioned that precipitous drop in the bean market?

Dr. GRAMM. Let me mention, as I stated earlier—you might not have been here—that we will be reviewing the emergency action that the CBOT took as we review all emergency actions. We will be reviewing the whole liquidation of that particular market, including whether or not they followed their own guidelines and procedures concerning conflict of interest. I have heard those charges, and we will be reviewing that.

Mr. GRANDY. But you are not prepared at this time to render a decision as to whether or not that fits your definition?

Dr. GRAMM. It is premature to say that we have concluded one way or another on those issues, but we are reviewing that.

Mr. GRANDY. Thank you, Dr. Gramm, Mr. Chairman.

Mr. ENGLISH. Mr. Penny.

Mr. PENNY. Are you going to make recommendations in terms of the practices at Chicago where they essentially reconstruct an audit trail instead of having a hands-on record immediately upon the completion of a transaction?

Dr. GRAMM. Well, yes.

Mr. PENNY. My understanding is in Chicago it is reconstructed——

Dr. GRAMM. That is right.

Mr. PENNY. And imputed as to when those trades took place, which is an awfully open-ended kind of system. It seems to me that if you are concerned about the potential for abuse, that we have got to do better than they are now doing. And if you do not want the legislation that we have proposed, what will you be proposing to help us move Chicago toward a system where the transactions are completed and recorded at the time they are completed, instead of reconstructing it at the end of the day?

Dr. GRAMM. We have reviewed the trade reconstruction systems that some of the larger exchanges have. These systems permit reconstructions of the trading, we believe, sufficient to give a pretty accurate audit trail. The systems use information from a number of other sources to actually reconstruct the trading sequence, which is, of course, what is very important with respect to detection of certain trade practice abuses.

Mr. PENNY. Can you help walk me through how they do that and what degree of integrity we can ascribe to that system? It just sounds to me like any time you are going to reconstruct the events you are going to have an awful lot of gray area.

Dr. GRAMM. Right. But you should remember that it is the exchange that is reconstructing the trading sequence pursuant to our rulemaking, and that we monitor for basically the verifiability of that information. And it is a somewhat complicated process, but let me just very briefly tell you how it is done. A trader, when he makes a trade, will give a time bracket when that trade occurred. In reconstructing the time sequence, the system uses a lot of other information, such as the information from the time and sales report, information from trading cards on which members are required to record trades in order, execution times for the trades that are of a certain type, and the entry times for customer trades. There are certain kinds of trades that they are supposed to be recording as well. So you are taking information from a number of different sources that will then, using the larger time bracket, develop windows in which trades can be located.

We would be happy to come up and provide you a lot more detail on that. But we have reviewed those systems and found them generally to be consistent with the requirements of the Commodity Exchange Act.

Mr. **Penny**. The New York Stock Exchange has a computerized system where I think they punch a card and send it through a machine and it gets automatically recorded at the time of the activity. Is it prohibitively costly to do something like that in the commodity exchanges? It just seems to me that the potential for abuse would be lessened if there were an actual recording done at the time of the transaction instead of, you know, maybe a listing on independent records here, there, and everywhere, and then trying to coordinate those at the end of the day.

Dr. **Gramm**. The independent records, such as the time-stamping of the order tickets before they come into the pit and after they leave the pit, provide other corroborating information. When we required the audit trail, the 1-minute audit trail, the exchanges came up with different ways of doing it, and they work differently. In some markets—for example, in one market in New York—the seller writes out an extra card that they put in the pit, and then it is taken by exchange employees and input into the system. That may work in some markets; it may not work as well in other markets.

Mr. **Penny**. If I might, Mr. Chairman, ask one other question, and this gets to the situation with soybeans last week.

Here in Congress, and in most public bodies, we have, if not in writing, at least generally understood policies about conflict of interest. And if you are directly involved in the S and L industry, you probably did not cast a vote on the S and L legislation a couple weeks ago.

What about those folks in the Chicago Board of Trade who stood to make a heck of a lot of money on soybeans last week, and yet might be on the governing board? Shouldn't we have some prohibition on their involvement in those kinds of decisions?

Dr. **Gramm**. Basically, the Chicago Board of Trade has a regulation that—again, it is the result of a Commission regulation. We require the exchanges to have conflict of interest policies with respect to members who might be on decisionmaking boards so that members taking action do not have a financial interest in the outcome. We will be reviewing the CBT order to make sure that those conflict of interest policies and related exchange rules were satisfied. We have received representations from the exchange that they were satisfied.

Mr. **Penny**. Thank you, Mr. Chairman.

Mr. **English**. Mr. Espy.

Mr. **Espy**. Thank you, Mr. Chairman.

I would like to get back to the whole matter of dual trading. I was late arriving at this committee. I was at a budget hearing. So if it has been asked before, I apologize. But within the bill which has been promoted and introduced, of course, dual trading is going to be outlawed.

Dr. Gramm, you mentioned the study or the review, rather, that you are undertaking at CFTC. I would like to know, as a part of that study, have you evaluated or is there any consideration to evaluate the extent to which foreign exchanges will be advantaged if we outlaw dual trading in our markets? In other words, if we outlawed dual trading, would our brokers and our traders automatically shift their focus to the London Exchange, for instance?

And is this a part of your study? If it is, could this committee trust a survey among your members where this question is asked?

How would you structure a survey to the extent that we could trust the answer?

Dr. **GRAMM**. Well, that is a very difficult question, and I think that the way we would address it is this way: That whenever we would do a rulemaking, we would want to make sure that the—excuse me for using these words—the benefits of what you are trying to do, if you are trying to ban dual trading, what would be the benefits there. And if the benefits exceed the cost, say if the benefits from reduced potential for abuse would exceed the cost of that particular rulemaking, then the implication would be that the impact on our markets would not be that great. But it is something that I think is always worth considering because these markets are very international.

With respect to making surveys about whether or not someone would move to a different market, for example, or whether or not trading would go overseas, that is always a difficult question. As economists, we tend to want to look at what people have done in the past and get our implications from that, rather than saying in X, Y, Z situation what would you do. So that kind of a survey may get some thoughtful responses and be something worth looking at. Again, it would be very difficult to say for a fact that it would have that——

Mr. **ESPY**. But what is your opinion? Do you think that this would happen? Do you think that would be a perceptible shift to something like the London Exchange? If we decided to outlaw dual trading, would they go automatically to another exchange where this is permitted, in your opinion?

Dr. **GRAMM**. I do not know that. I mean, it depends on—one thing I would say is that there is a certain amount of flexibility in the proposal that is in the package here. And with some changes and through rulemaking, one could try and ensure that the costs would not exceed the benefits. But, again, I would stress that there are a lot of things about dual trading, both on the cost and benefit side, that really need, indeed beg for study and careful analysis. A rulemaking procedure allows the Commission better to assess that.

I could not make that judgment right off the bat right now.

Mr. **ESPY**. Thank you, Mr. Chairman.

Mr. **ENGLISH**. Thank you very much, Mr. Espy.

Mr. Morrison.

Mr. **MORRISON**. Thank you, Mr. Chairman.

I would like to concentrate my questions on information that I think would be important to this subcommittee as we go about reauthorization, our response, what needs to be fixed. The first question, you mentioned two different things you are studying. One was the dual trading study, as I recall, that is due out in October.

Dr. **GRAMM**. Yes.

Mr. **MORRISON**. The second was the study of the broker association, its relationship with the process, and that is due out in August. Did I miss any evaluations that you are going through formally?

Dr. **GRAMM**. We are always evaluating a number of other things, and there are a number of other proposals that we have. We have two rulemakings on—we are reviewing oral orders. We are doing a rulemaking—well, that would bar members that have a significant disciplinary action from serving on a disciplinary committee.

Mr. MORRISON. Probably the two that you have mentioned would be of greatest significance to us in our deliberations.

I was also wondering if you could share anything at all with us. Our investigation team working for the chairman has not had anything at all they could share with us from the sting operation and when we are likely to get any information at all from that activity. Can you share anything at all with us?

Dr. GRAMM. I am afraid that that information would have to come from the Justice Department, and I think they are not sharing that information either.

Mr. MORRISON. You have no idea on time?

Dr. GRAMM. It is not something that we could disclose.

Mr. MORRISON. I am somewhat frustrated because, as Neal Smith indicated, we finally have stepped in, and we have found out what is wrong. And yet we do not have any idea what was wrong or how to fix it because we do not have access to that information.

Dr. GRAMM. I understand that and have made those views known to the Justice Department as well.

Mr. MORRISON. Mr. Chairman, I guess I express a concern. We have got several things that I think would be very important to us, the dual trading study and the broker association study that are coming later, and also I would hope at some point we would get some information from the Justice Department. It is your inclination, though, to proceed with this bill rather rapidly.

Mr. ENGLISH. If the gentleman would yield, that would be my intent. Let me say, too, on the issue of the study, how many studies have you done with regard to dual trading since the CFTC was formed in 1974? If I remember correctly, you have had a study on dual trading ongoing just about ever since, have you not?

Dr. GRAMM. Well, we were asked in 1982 reauthorization to undertake——

Mr. ENGLISH. I think you were asked before 1982, were you not?

Dr. GRAMM. In 1976 as well.

Mr. ENGLISH. In 1976 you were asked, and in 1982 you were asked. These studies have been ongoing, that have been completed. So, you know, that is the whole point. I am getting a list of all the studies as to how many studies the CFTC has going on these days. They are just about studying everything to death. I think it is about time that we act. We need a little action, and that is the whole point.

The question I think that we have before us that the members are going to have to decide is the question of whether we are going to raise the standards. That is the basic issue. Then the question is: In what way we do that? Now, as far as any action with regard to the U.S. attorney in Chicago, Mr. Coleman and I both approached the Justice Department, the Attorney General, requesting information. We do not know whether that is coming next week, next month, next year, as far as any action by the Justice Department. The CFTC is going to be out of existence by the end of this year, or I should say by the end of this fiscal year, September 30. And I think the real issue is whether we are going to act.

If there are any surprises that should come out of the action of the Justice Department, it is certainly my intent to take it up and pass on in a timely manner, as we would any other shortcomings that we might find. But I think that it would be a mistake to leave the CFTC hanging in limbo as we hope that some time before September 30 the Justice Department may or may not act.

Mr. COLEMAN. Would the gentleman yield?

Mr. MORRISON. I will yield.

Mr. COLEMAN. I would like to comment on your concerns because they are my concerns as well as far as the investigation and the information that could help us in addressing some alleged wrongs that may have occurred in the Chicago pits.

Now, we did ask the Justice Department if we could talk with them, even in a generic sense. We do not want to know the individuals involved or particular transactions, but if we could talk generically about things so that we might have the benefit of their investigation and information they have developed to this point. They refused on the basis that it is an ongoing policy of the Justice Department not to comment or provide any information prior to indictments when it then is a matter of public record.

Well, no indictments have been forthcoming to date. Therefore, no information has been forthcoming to date, and we have been told that we are not going to receive any information. Based upon the theory of obstruction of justice that somehow just the discussion of these things on the cases involved and so forth would have an impact, we accepted that, did not pursue it, and agree with the chairman that if and when anything develops out of these investigations that are not covered by current law, or wrongs that might have been observed and documented that are not covered by current violations, then we would certainly, I think with great expedition, write new amendments to the law.

So I think that the gentleman has a good comment. It ought to be stated on the record exactly where we are in that process. Dr. Gramm herself is bound by the same rules as the Justice Department and has likewise refrained and, in fact, has not provided us any information. We will respect her position, which is a little bit different than Justice, but recognize her limitations as well.

Mr. MORRISON. I thank both my chairmen for the information. I am not surprised by the answer. I just would love to have that sort of tool to work into our deliberations.

Mr. ENGLISH. If the gentleman would yield, I would agree. We would love to have all the information that the Justice Department may have or anybody else. But let me make one other point.

I think, too, in carefully weighing this, we looked at this very, very closely. It is highly unlikely that the action taken by the Justice Department either is not already covered by current law or is not covered by this legislation. So, you know, the overwhelming odds are that that is something that is not going to have any bearing. But I think that we all recognize that if there is that chance, if there is something that should crop up that should require action, I think you are going to find that Congress is going to be very eager to deal with that in an expeditious manner, and certainly this subcommittee will.

I thank the gentleman.

Mr. MORRISON. As a member of it, I would be disappointed if we did not immediately leap to the challenge. I still want to know what the FBI did.

Mr. ENGLISH. Mr. Nagle.

Mr. NAGLE. I want to go back to this, if I can. I know you have talked about it quite a bit, but I want to go back to the actions of the CBOT last week with regard to soybean futures. Prior to the action of the CBOT in ordering the divestiture of soybean futures by certain groups, who stood to make money? Who was in the position to profit before their action?

Dr. GRAMM. Depends on what the action was, I guess, and the impact on the market.

Mr. NAGLE. Well, let me just walk through it with you so we are going on the same track here. I understand that before the action of the CBOT that an Italian organization or firm or company had managed to capture a good portion of the July futures market on soybeans. Is that correct?

Dr. GRAMM. I think that—typically, I like to discuss how we do these things and how we monitor for orderly liquidations without getting into specific names of participants in the market, particularly when the market is still open and before we have finished our review of it. We have indicated that we have had concerns about the orderly liquidation of the market because of the large open interests relative to deliverable——

Mr. NAGLE. Well, I do not know why we cannot talk about it. It was on the front page of every paper in the country last week. It was—how do you pronounce it? Ferruzzi?

Dr. GRAMM. Again, it is a situation not unlike the FBI probes where, again, we are going to be reviewing these actions.

Mr. NAGLE. Mr. Chairman, could I have your copy of the Wall Street Journal article?

I have the Post and the Journal.

Dr. GRAMM. I think the important factor——

Mr. NAGLE. Now, if the Wall Street Journal can talk about it, why can't we?

Dr. GRAMM. Well, I think the important factor, the issue that you raise in your question, is what would have happened in the market and what is the price impact. And, again, that is sometimes hard to predict, what the specific price impact of specific actions would be.

Mr. NAGLE. I may have misunderstood you, then. I apologize. I thought you said that CBOT took the action and you affirmed it.

Dr. GRAMM. No. We will be reviewing the emergency action.

Mr. NAGLE. And you have made no response to CBOT in the interim? I misunderstood that.

Dr. GRAMM. No. We have discussed the situation with the CBOT in our monitoring of the markets, but we have not judged, made the judgment yet with respect to their emergency action. That is something that is part of our review that would occur after—whenever an exchange——

Mr. NAGLE. I just want to understand this. Did you talk to CBOT before they took the action?

Dr. GRAMM. Absolutely. We had been in contact with the CBOT, in discussions with them, really for several months, even.

Mr. NAGLE. For several months?

Dr. GRAMM. That is right.

Mr. NAGLE. Did CBOT tell you that they were going to take this action before they took it?

Dr. GRAMM. Yes.

Mr. NAGLE. Was there a decision made not to—what did you tell CBOT when they told you they were going to do that? Say "OK?" "Don't do it?" "Better wait?" "We don't know anything about it?" "We can't talk about it?" What did you say?

Dr. GRAMM. No. I thanked them for the information.

Mr. NAGLE. That is it?

Dr. GRAMM. Yes.

Mr. NAGLE. That constitutes the oversight, the CFTC oversight?

Dr. GRAMM. No, absolutely not. No.

Again, we had been monitoring these markets and had, indeed, monitored even the May expiration because there were some concerns in the May expiration. We had had discussions with not only the major traders but also other participants, had been discussing the market with the CBOT and the concerns they raised, had discussed even alternatives. But, again, they made the decision and their committee made the decision about what particular emergency action they were going to take. That was something that they relayed to us. We have had discussions with them since then, again, sharing information about what has happened in the market. That is our normal behavior.

Now, whenever any emergency action is taken such as this, we review all trading in that particular market. We review their action. We review the procedures that they follow.

Mr. NAGLE. Why was it—waited until apparently the third week of July or the second week of July if this thing had been monitored since—what, you said as early as May? That it was becoming apparent that one company was cornering the soybean futures for July? Why did you wait until——

Dr. GRAMM. Again, let me speak about what we typically do in monitoring for orderly liquidation of a market, and that is not to prejudge the case in point. But what we do, as the exchange does, they have the responsibility to monitor for orderly liquidation.

Now, where congestion may occur typically is as the contract liquidates. So as we get close to the contract expiration period is when we start to monitor very closely about what the intentions of the traders are, those with, for example, large positions and whether or not they expect to stand for delivery, to determine whether or not there could be particular problems. That is something that Commission staff does regularly for any market that may have a concern. And, again, any action that needs to be taken may well occur toward the end of the contract period, toward the expiration date, rather than earlier on.

Mr. NAGLE. Well, speaking generically, without naming companies, it would seem to me that a fair summation would be that one company that had bought a lot of July futures, a foreign company, and a lot of individual farmers who had bought July futures would probably have been hurt by CBOT's action, and companies that had filled July orders would probably have benefited. Would that be just kind of a fair overview?

Dr. Gramm. Whenever you have an emergency action, there will be—and because these markets are basically a zero-sum game, there will be winners and losers, depending on what happens in the market.

Mr. Nagle. Who won? Who lost? Just generically speaking, who won and who lost?

Dr. Gramm. It depends on what those individuals in those markets were doing, basically.

Mr. Nagle. Broadly speaking, who won and who lost?

Dr. Gramm. Let me turn to Dave Kass, who is the Chicago Regional Office Director, who could clarify.

Mr. Kass. Basically, unless you know one individual circumstance, he may have been spread, for example, long July, short August; may have been hedged so that any price movement in the futures market would have been offset by depreciation or appreciation in the cash market.

To say who won or who lost, you would have to grab some individual and say, you know, what was your circumstance on that——

Mr. Nagle. Well, we know one company that lost, and that was Ferruzzi, right? They clearly were a big loser when you ordered the sale.

Dr. Gramm. Let me just say——

Mr. Nagle. Can I just get that question answered yes or no?

Mr. Kass. It is a question that does not have that kind of an answer.

Mr. Nagle. They are unhappy because they won? I mean, I am reading the paper——

Dr. Gramm. I think it is clear they are unhappy.

Mr. Nagle. It does not look to me like they are very pleased.

Mr. Kass. Let me just say, to the extent that any long trader in the market with long futures positions has a hedge against purchasing soybeans down the road, for either export or processing—this is any long trader—the fact that now they would no longer be able to hold, say, a hedge in this market, obviously whether they have won or lost will depend later on what they will be able to buy those soybeans for in a cash market. If they are, indeed, able to acquire them for much lower prices, they even could have some advantage. But they have lost the hedge.

What the ultimate result is going to be may very well be the subject of lawsuits and everything else down the road. But in terms of any one individual trader to say who won or who lost—to the extent there was demand for soybeans in this market, as evidenced by long hedges against needs, that demand did not go away as a result of the emergency action. The demand for those soybeans is still in the market.

Mr. Nagle. Mr. Chairman, if I could have the indulgence of the committee to pursue this just for 1 minute.

You mean the CBOT talks to you, you talk to them, and then you take this action, and you do not know when you take the action, or when you say, "OK, thanks for informing us," what the impact on the individual market traders is going to be?

Dr. Gramm. It is not quite that.

Mr. Nagle. And even 1 week later, you do not know, have not got any idea?

Dr. **Gramm**. No, that is not quite that. It really is, again, a cooperative and—well, let us not put it that way. It is a kind of action where the exchanges have the responsibility to ensure orderly liquidation, and we have the responsibility to ensure that they do. And, generally, if the situation were to arise that we feel like we need to take an emergency action, or that the exchange has not taken sufficient action, then we can act.

Mr. **Nagle**. You mean you could have said to CBOT, "Don't do this?"

Dr. **Gramm**. We could have. We could have, yes.

Mr. **Nagle**. So by saying, "Thanks for the information," you in essence said "Go ahead."

Dr. **Gramm**. No. Their board made the decision to——

Mr. **Nagle**. But you could have stopped it.

Dr. **Gramm**. We could have taken an—there are a number of emergency actions that we can take.

Mr. **Nagle**. You could have stopped the sale?

Dr. **Gramm**. Yes.

Mr. **Nagle**. Thank you. And so by not stopping the sale, you in essence approved of it?

Dr. **Gramm**. No, no. Again, it is their responsibility to ensure orderly liquidation in the markets, and it is their responsibility first and foremost. Now, we review these actions, all along, so if we think that the action was not sufficient, we could take other action even toward the end of the market, the market is still open.

Mr. **Nagle**. Well, let me just say this, and I thank the chairman and the committee members for their indulgence. You know, in trying to do this reauthorization, the fact that you have been monitoring the situation since May, we come to the last possible minute and you could have ordered the liquidation sale before then, you could have blocked the liquidation sale—and, indeed, I think some serious consideration should have been given to that, given the outcry that it created and the lack of confidence that has eroded from the markets. I do not find your answers—and I do not mean this harshly, but I do not find your answers very confidence-inspiring. I mean, you cannot tell me who won, you cannot tell me who lost, and you cannot tell me who is trading even though I can read about it in the paper. You cannot tell me what conversations you had, and I have to drag out of you the fact that you could have blocked the sale.

Dr. **Gramm**. These markets are still open, and I would point out just several facts that I pointed out earlier that we did have a significant inverse before the emergency action, where the July premium to the August premium had reached over 40 cents, which is the largest July premium in at least the last 6 years. We had an open interest of 40.3 million bushels with a deliverable supply that was about 12.7 million bushels. In the 4 trading days since the emergency action, the congestion seems to have been reduced. The July futures premium to the August future has declined to about 15 cents, so it appears that the congestion has been reduced. And I think one ought to remember why it is important to ensure orderly liquidation of the markets. It is something that we require.

An example was what the exchanges undertook several years ago to ensure orderly liquidation of the triple-witching day, for example. Orderly liquidation of a market is very important. If you do not have orderly liquidation of a market, you will have a——

Mr. NAGLE. Dr. Gramm, we are not arguing about orderly liquidation here. We are arguing about an action taken by CBOT that seemed to benefit some customers at the expense of others.

Dr. GRAMM. Any time there—and, again, as I mentioned earlier in private, any time there is an action, emergency action that is taken, given the nature of the markets, there are some that benefit and some that lose——

Mr. NAGLE. But we cannot——

Dr. GRAMM. With respect to their positions, that that is why the whole issue of the conflict of interest and the procedures that they followed are very important, and that we will be reviewing in this case as well. These kinds of arguments, the concerns raised as well as the complaints raised by people, are not unlike the kind of complaints that you would hear in any emergency action that any exchange had taken of this nature. So it is expected.

Now, what we do is we again have to monitor the markets, and again remembering that the public confidence in these markets would be hurt in a far greater—have far greater impact if there is not an orderly liquidation. And that is a real concern, that these markets are not markets that are here primarily for taking delivery of the physical old crop July beans. These markets are primarily there as hedging markets. And it is the responsibility of all participants in the market to ensure that they are abiding by the rules of the game, the rules that we play in this country, to ensure that there is, for example, orderly liquidation all the time. And participants must know and play by the rules of that game.

Mr. ENGLISH. I think we will have another round of questions. This does complete the first round. We have the honorable chairman of the Wheat, Soybeans, and Feed Grains Subcommittee, a person who has a great deal of knowledge in this particular area. Dan, we are glad to have you join us today.

Let me say one thing before Dan asks his questions. We checked and there are some 14 studies presently ongoing by the CFTC in the fourth quarter of this fiscal year. So you have a lot of studies going, and we look back to the act when it was first created, and you started out with dual trading on that one. So you have studied dual trading for about 15 years now, off and on. Is that not correct?

Dr. GRAMM. Yes, but, again, I would point out that——

Mr. ENGLISH. Well, is that true or not?

Dr. GRAMM. We have a lot of studies——

Mr. ENGLISH. Have you studied it for 15 years off and on?

Dr. GRAMM. Probably so, but we have never had audit trail information. And we did not get audit trail information until quite recently. And I do not think you can really measure the benefits from dual trading until we have that audit trail information.

Mr. ENGLISH. We have had an audit trail for 4 years, and I suppose, Dr. Gramm, if we really want to get into it. And if you want to hang around here this afternoon, I will be happy to do it, as to how well that audit trail is working, how much of that information is being provided, and how good of a system that really is.

Now, if you want to do that, I will be happy to do it. The point that I am making, though, is that the CFTC has looked at the question of dual trading now for 15 years—15 years. They do a great job of studying. We have a lot of studies going. We have, as I said, 14 going on just in the fourth quarter of this year. Goodness knows how many others. And I think that is fine, but at some point we have to do something with all this studying. It has to come to an end.

As I said, the whole thrust of the legislation, of this effort that is being made, is raising the standards. If the CFTC and you want to join with us in showing us how we are going to substantially raise the standards as opposed to settling for the status quo today, I think we would be delighted to hear from you on that. And I hope that you all will help us in that area.

I think the point that Mr. Nagle made, you know, the CFTC simply cannot sit on the sidelines and assume, simply because "Thank you very much" means, you know, nothing, it is wrong. As Mr. Nagle just pointed out, it means acquiescence. In effect, it is tantamount to approval.

Dr. GRAMM. On the contrary. I do not think that we are just sitting on the sidelines, either on the soybean case or on all these studies. I think the fact that we have a large number of studies ongoing indicates that the issues that this Commission faces every year changes. And so the studies that we are doing on broker associations, which is a relatively new phenomenon, for example, is something that would not have existed a long time ago; that as we learn more, we will have more studies, but we are also doing quite a bit.

The Commission was not standing on the sidelines in proposing audit trail, for example. That was a Commission regulation, a proposal that really grew out of one of the dual trading studies earlier on, so that these studies do produce quite a bit of action. And we have been quite active at the Commission not only studying but also undertaking rulemaking and actually doing things, helping write new legislative proposals, for example. And we do stand ready to, again, take the results of these studies to further improve our markets because they are innovative and markets with a lot of public confidence. But that's not to say that they are markets that are standing still.

Mr. ENGLISH. Mr. Glickman.

Mr. GLICKMAN. Thank you very much. And thank you, Mr. Chairman, for allowing me to ask questions even though I am not a member of this prestigious subcommittee and wish I were.

Dr. Gramm, do futures exchanges have to submit to you in advance of formal action taken emergency action orders by those exchanges?

Dr. GRAMM. No, they do not.

Mr. GLICKMAN. So the CBOT could take an emergency action without notifying you in advance?

Dr. GRAMM. That is correct.

Mr. GLICKMAN. In this case, however, they did notify you in advance?

Dr. GRAMM. They did.

Mr. GLICKMAN. And you under the law have the authority to intervene or to veto that proposed emergency action?

Dr. GRAMM. Hypothetically, we could take an emergency action that would be counter, that would basically moot their emergency action.

Mr. GLICKMAN. I want to understand. Under the law, you have the authority to take emergency action of your own, right?

Dr. GRAMM. That is right. That is correct.

Mr. GLICKMAN. You could have taken an exact similar action on soybeans that they took?

Dr. GRAMM. Yes.

Mr. GLICKMAN. Without them approving or acquiescing at all?

Dr. GRAMM. That is right.

Mr. GLICKMAN. And in addition to that, they can take that action without your approval?

Dr. GRAMM. That is right.

Mr. GLICKMAN. Isn't that a mistake? Should they not require at least—is there no requirement of notification to you if the exchange takes an emergency action?

Dr. GRAMM. They do have to—there are some requirements in the act. If an emergency rule, for example, were to be in existence beyond 30 days, then they have to come to us. But let me turn to——

Mr. GLICKMAN. Well, I do not want to get into a long, lengthy analysis of this right here.

Dr. GRAMM. They do have to notify us after the fact by the fastest available means.

Mr. GLICKMAN. What is that? Federal Express?

Dr. GRAMM. Telephone, I would guess, and fax.

Mr. GLICKMAN. But in this case, you were talking to them periodically, and you knew in advance they were going to take the action, right?

Dr. GRAMM. Had reason to believe that the board, yes, would be taking that action, the recommendations.

Mr. GLICKMAN. Well, I think Mr. Nagle's point is an excellent point, though. Once you know they are going to take an action and you have been on the phone with them, unless you give them a negative point of view, they have to assume that they are taking that action under your auspices?

Dr. GRAMM. Well, again, you have to bear in mind that what the board actually decides at a meeting to consider recommendations, for example, from the committee that is monitoring the situation, could be different from what is recommended. We had an indication of what things might be recommended, but, these may or may not have been what actually was decided in the board meeting.

Mr. GLICKMAN. Mr. Chairman, I suggest that in the authorization process you ought to look at this relationship between the futures exchanges and the Commission when emergency actions are taken to make sure there is not a gap there.

Second question on dual trading: Has the subject of front-running been discussed today at all?

Dr. GRAMM. No, it has not been.

Mr. GLICKMAN. OK. Can you define the difference between front-running and dual trading?

Dr. GRAMM. Dual trading simply refers to the fact that in futures markets an individual can trade for his own account and for his customer's account on the same day.

Mr. GLICKMAN. OK. Front-running?

Dr. GRAMM. Front-running refers to—and it is usually in this context referred to intermarket front-running—a person uses nonpublic information about a position to take a different position in another market expecting the first position to have a price impact on the second. So it is the use of material nonpublic information about a position or an incipient action in one market and profiting, or taking a position to profit from that information in another market.

Mr. GLICKMAN. Is front-running a clear violation of Federal criminal law?

Dr. GRAMM. We believe that it is a violation of the criminal law because it would be abusing the information.

Mr. GLICKMAN. But there is no Federal front-running statute right now, is there?

Dr. GRAMM. There is no Federal front-running statute.

Mr. TALLON. Would the gentleman yield?

Mr. GLICKMAN. Yes.

Mr. TALLON. Dr. Gramm, how many people have ever been convicted on criminal charges by the Justice Department for trading ahead or front-running in the futures industry?

Dr. GRAMM. Let me turn to my enforcement director.

Mr. KLEJNA. We could get you exact figures, but it is a very rarely prosecuted matter. Typically, when a U.S. attorney is going to bring criminal charges, they will utilize the mail and wire fraud statutes rather than the Commission's antifraud statute. Nevertheless, there was a case which went to the seventh circuit in Chicago which started as a Commission enforcement action and which was a trading-ahead case brought under the mail and wire fraud statutes. It was also prosecuted by the Commission's Enforcement Division under the Commission's antifraud provision.

Mr. TALLON. Thank you very much.

If I would suggest to my colleague from Kansas, I believe very strongly that we should consider putting criminal charges in this legislation, criminal charges for trading ahead, or front-running.

Thank you.

Mr. GLICKMAN. Do you agree with Dr. Gramm's statement that front-running is trading ahead of an account that affects another market? Could you not have front-running with respect to the same markets that you were trading in?

Mr. KLEJNA. I think that we would call that trading ahead.

Dr. GRAMM. Trading ahead.

Mr. KLEJNA. Absolutely trading ahead. Trading ahead of a customer order by a commodity professional, there is no doubt in our mind, would be a violation of criminal law.

Mr. GLICKMAN. Of course, some of the charges in the Chicago cases right now are trading ahead and perhaps front-running; is that correct?

Mr. KLEJNA. According to the public reports.

Mr. GLICKMAN. Do you think it would be a wise move for this committee to specifically make those charges criminal now? Or do you think if we did that it could jeopardize the criminal prosecutions that are undergoing by the FBI? See, I want to make these things criminal, but I do not want to let loose some crooks because we have now said something is criminal that maybe we are not sure was criminal before.

Dr. GRAMM. I think that is a very good point, and I would ask Dennis to amplify on this. The concern would be that by making it criminal, something that already is criminal under our statute, that it would call into question whether or not trading ahead of a customer is a violation of the act. And that would be a problem.

Mr. TALLON. If the gentleman would yield?

Mr. GLICKMAN. Yes.

Mr. TALLON. I disagree. I think it is absolutely imperative that it be made criminal in this legislation. We have no record of the Justice Department coming in and prosecuting on criminal charges people who were trading ahead of customers.

Mr. GLICKMAN. Well, the best way to handle this is to move ahead with making trading ahead a criminal statute, and let us hear from the Justice Department. They are the ones that are prosecuting this case. If they think that trading ahead statute would jeopardize a whole series of criminal indictments, then let us hear from them. But it is hard for me to believe that we should not make that a specific criminal statute.

Mr. ENGLISH. If the gentleman would yield on that point, we have asked the Justice Department for that information. It is my understanding that unofficially, as they are preparing a letter for us, unofficially it is their opinion that that would jeopardize those cases, and it would call them into question now.

Now, it is also my understanding—we would like CFTC to comment on this—that the problem comes in not with the question of whether this is, in fact, a criminal violation. The issue comes in getting the U.S. attorneys to prosecute, just getting the U.S. attorneys to take it to court. Is that the gist of the problem, Dr. Gramm?

Dr. GRAMM. Occasionally. We have worked hard to promote cooperative enforcement, and I think in the past we have had to do a pretty good sell job to get them to take some of these cases. Now, I do not know specifically about the trading ahead cases.

Mr. KLEJNA. I do not think that anybody would think that the current posture of the U.S. attorney's office in Chicago with respect to these prosecutions or any matter about them is anything but enthusiastic.

Dr. GRAMM. That is right.

Mr. ENGLISH. The point I am making is not with the U.S. attorney in Chicago. I am talking about historically speaking. It is my understanding that the CFTC has had difficulty in interesting U.S. attorneys in this particular subject. It is difficult to get him to prosecute, which explains the lack of action in this area; is that correct?

Mr. KLEJNA. Outside of the current situation in Chicago and a few others, we have tried very hard to interest U.S. attorneys in commodity fraud prosecutions, and it has been, frankly, some tough going, as the Chairman has indicated. That is right.

Mr. GLICKMAN. I just would make the point, I suggested earlier on this year that we ought to ban dual trading. But I think what we want to ban is the illegal conduct. And I guess my fear is that until such time as you have the adequate audit trail requirements, you have to ban the trading because you cannot seem to get to the conduct. I do not know. It is an unclear question.

The real problem is not front-running or trading ahead. It is the illegal conduct that is the problem because that is when you are abusing the public trust as well as the private trust. But if you cannot target it with a scalpel, then you almost have to bludgeon it to death with the absolute ban of dual trading, or something along with what the chairman has recommended.

Mr. TALLON. If the gentleman would yield, I just want to associate myself with his remarks, and I also want to state one more time: If it is a criminal felony now, it will be a criminal felony when we put it in this legislation, and it ought to be there.

Thank you.

Mr. GLICKMAN. I thank the chairman for recognizing me. I want to also compliment him, Mr. Coleman, and Mr. Penny for the two sections of this bill requiring some independence on disciplinary committees, as well as requiring some public membership governing boards. I think those are excellent provisions.

Mr. ENGLISH. Thank you very much. We appreciate it. Of course, I am sure the gentleman recognizes that the legislation has improved, as it has been introduced, at least, does do exactly what he is talking about; namely, that it does set up procedures that if, in fact, any type of fraud whether it be front-running or anything else, can be detected, so long as the system can detect it, it is fine to do dual trading. But if it cannot be detected, then it is banned except under certain conditions which the CFTC is allowed to impose. And so we try to provide that type of flexibility he is speaking about, and I appreciate that.

Let me say before we start our second round, there is the question with regard to permanent status, and I want to make sure that we have this in the record and that it is very clear as to what the intent is. It is the intent that the CFTC will come before the subcommittee at the beginning of each new Congress and present a budget for the next 2 fiscal years. We will consider that request and initiate a bill to authorize appropriations at the appropriate level. We will not consider any other legislative proposals at that time. That does not mean, of course, that we will not restrict funds. We will identify where funds will be spent and so forth.

It is my further intention that this subcommittee will oversee the CFTC's activities continuously, and at any time that we find it necessary, we will propose and consider legislative changes. The CFTC will be expected to propose legislative changes at any time that the Commission deems it necessary. From this point forward, let everyone know that the CFTC is considered to be just as permanent as the Department of Defense or the Securities and Exchange Commission. These agencies and many others come before their authorizing committees annually and biannually to request authorization for funds for their functions. This, of course, does not relieve the CFTC of appearing before the Appropriations Committee to defend its request and our authorization. But this process tells the world that the CFTC is a permanent organization, that its authority will continue, and that this subcommittee and the full committee will have a role in deciding how the CFTC will be funded instead of simply leaving it to the Appropriations Committee. So I want to make sure that is very clearly understood.

I want to come back again and underscore that the purpose for providing this permanent status is not to be taken that this subcommittee or myself or any of the other authors of this legislation are saying that the CFTC has done such an outstanding job and is so perfect that we want to bestow this on it. Instead, the intent is to strengthen the CFTC, to make certain that the CFTC has the resources and has the support of Congress, and that it is clearly understood in carrying out its responsibilities.

Dr. GRAMM. We appreciate that support and also——

Mr. ENGLISH. Well, let me give you the "but" before you get to that.

Dr. GRAMM. All right. I thought I would be able to cut it off. [Laughter.]

Mr. ENGLISH. You may decide the "but" is not worth the first part. The "but" part of it is this question of elevating the standards. That is the quid pro quo of permanent status for the CFTC. We strongly believe that the standards have to be substantially increased and improved, and the purpose with regard to the other provisions of this legislation is to try to put that in place. What we are, in effect, saying that these standards shall be met, or there will be no dual trading or there will be no new contracts or this or that. It is not a question any more of setting standards at certain levels. We are stepping in at this particular point, and we are trying to make it very clear that we expect those standards to be elevated. And we think that is something, certainly, that we would hope that the CFTC would join with us in a vigorous manner in helping us to reach those objectives.

I just wanted to make that very clear, and I also wanted to make it clear as far as exactly what this permanent status means.

Dr. GRAMM. Absolutely. We appreciate that support, and we do recognize—the whole Commission has always been very supportive of very strong congressional oversight. Our view is that the more people who have scrutinized and looked at what we have done, that even if we cannot talk about certain issues on an ongoing basis like investigations, et cetera, that nonetheless, upon close scrutiny, as a number of outside people have done as well as congressional bodies, that it has been good.

Mr. ENGLISH. We will try one more quick round. The chairman will do his best to adhere to the 5 minutes and hope everyone else will, and then we will break for lunch.

I want to go back to the soybean issue and discuss this a little bit more. The question comes down to the procedures. You responded to Mr. Glickman's questions about procedures. I am more interested in the mechanism and the attitude of the CFTC than I am specifically who did what on what day. But as far as the way that this kind of action is, I do not understand it. The exchanges are under no obligation, the way that you responded to the question, they are under no obligation to in advance of this decision notify the CFTC.

It is only after the fact. "We have decided this is what we are going to do." Is that correct?

Dr. GRAMM. Basically, yes. But basically when an exchange is going to do an emergency action, they have notified us. They do notify us, particularly when we are talking about an orderly liquidation which is so important; there is a constant interactive process going on. In fact, as long as I have been here, the exchanges have told us beforehand when they were thinking about doing emergency actions and the reasons for doing it. And I think that communication is beneficial to our oversight.

Mr. ENGLISH. Well, I agree with that, and that is all well and good. I want to cut through, though, what the exchanges normally do or may do.

Dr. GRAMM. Right.

Mr. ENGLISH. I want to get down to specifically what is required of the exchanges, what options the CFTC may have available to it. As I understand it, there is no obligation, the exchange does not have to notify the CFTC until after the action has taken place. Is that correct?

Dr. GRAMM. That is true.

Mr. ENGLISH. Now, what would be your position in possibly changing that notification?

Dr. GRAMM. I think there is a difficulty that I can identify, and I will turn to some of my experts on this. That is, let us suppose you have an emergency situation occurring that the board of an exchange or a committee of the exchange would want to take action on. They may notify us that they are going to do it or have a reasonable expectation of doing it. But in that process, the board may decide otherwise based on other information.

Mr. ENGLISH. The problem we are into, though, Dr. Gramm, on this issue—and it goes, really, to part of what is in this legislation, part of which, if I remember correctly, you are not very enthusiastic about. And that gets into the question of public members on the board.

Now, as it stands now on a number of these exchanges, primarily what the board is made up of are the brokers. The action that they are going to be taking to a great extent is what is going to be in the best interest of those brokers, what is going to be in the best interest of that exchange, which is an entirely different responsibility that, at least the way this member sees it, that you as chairman and the members of the Commission have; namely, to look out for the American public and make sure that the integrity of these markets is maintained. So I guess the question that comes into play here is that it would seem to me to be a mistake to assume that the exchange interest and the CFTC's obligations are one and the same.

Dr. GRAMM. Well, first of all, with respect to the issue of governing boards, that is something that the Commission identified quite some time ago. I think that following the short silver study, we made recommendations concerning the public members on the board, where the public members serve as a witness. As I indicated earlier, we do monitor the boards to ensure that they are broadly represented.

Mr. ENGLISH. As I remember in reading your testimony, going over your testimony here, basically it is you do not want to establish any levels; you kind of want to leave to leave it up to the exchanges, kind of leave the flexibility, which seems to me you want to water down basically what is in the legislation.

Unfortunately, my time is up. But the point I am trying to make is that there are two different interests here that have to be recognized, and it may be that the committee may want to look very carefully at that aspect.

Mr. Coleman.

Mr. COLEMAN. Mr. Chairman, let me clarify something. Mr. Glickman made a comment, and Mr. Tallon made a comment. I do not want the impression left that somehow H.R. 2869 is soft on front-running because we have not made it a crime. There were reasons given why it was not, but let me remind the subcommittee that the prohibition on dual trading is much stronger. So I think we have gone one step further, just to prohibit it, so there could not be a crime—there could not be the opportunity for a crime to occur. I think we have removed the cause of this concern, and I want the record to show that.

There are some who are suggesting to make this a crime and then do away with all the prohibitions or limitations on dual trading as a quid pro quo, and I suggest we intentionally did not put that in this bill because we think we have a better way of handling it. And I know that some have a different opinion, but I want the record to show what our intent was—including Mr. Tallon's opinion on this.

Mr. TALLON. Would the gentleman yield?

Mr. COLEMAN. I will yield briefly.

Mr. TALLON. Briefly. My concern is the negative impact that banning dual trading would have, which is completely legal, the negative impact it would have on the liquidity of the market.

Mr. COLEMAN. We are going to get into that, I think. We can get into it with Dr. Gramm. We can get into it with the exchanges. But let me ask a question because it is an auditorial question. You may want to refer to some of your panel of colleagues there.

On page 8 of your testimony, you talk about the 1-minute trade timing requirement and moving the industry toward an ability to improve their audit trails, et cetera, et cetera, and talking about the potential of these capabilities—we are talking about computer audit trails, of course—and achieving their potential, whatever that might be. Now, that is in your statement. There are no goals that I know of or stated standards getting to there.

Having said that, let me point out that in our legislation we have given you, the Commission, the determination, responsibility, and the authority to review what the exchanges come up with under our 1-minute time and our 30-second time execution and transaction verification trail. But you have to come up and say, yes, that meets the approval of the Commission of rapidly reconstructing an accurate verifiable record of these transactions as determined necessary by the Commission to provide the effective enforcement of the applicable provisions of this act, regulations, et cetera. You have no standards now. We have given you this responsibility and flexibility.

Now, let me ask you: Currently, what goals do you have in mind? What requirements do exchanges have as far as audit trails and the actual reconstruction of those transactions? Is there such a standard today?

Dr. GRAMM. Yes.

Mr. COLEMAN. And what is that?

Dr. GRAMM. The standard that we have in our rule is a 1-minute verifiable audit trail. Now that the audit trail has been implemented, we have done a first-pass review over the audit trails that cover roughly 95 percent of trading. In this review, we did raise a number of issues that could further improve the audit trail data. But we do have a standard in existence now, and we are asking the exchanges, and ourselves, about what further improvements in the audit trail might be appropriate.

Mr. COLEMAN. All right. But is there a figure? When you reconstruct trades, do you get an 80 percent accuracy rate or 90 percent or 95 or 99 or what?

Dr. GRAMM. That is right. We do in our rule enforcement review look at the verifiability, the level of confidence in those particular numbers. With respect to some of the computerized systems, they automatically calculate those confidence levels. So we have not only just the number but also some sense of the accuracy of those data.

Mr. COLEMAN. I am trying to get the number. What is the number?

Dr. GRAMM. It differs for different exchanges.

Mr. COLEMAN. OK. What have you found to be the highest accuracy?

Dr. GRAMM. Over 95 percent in some exchanges.

Mr. COLEMAN. And what exchange was that?

Dr. GRAMM. Let us see. Which exchange? Let me turn to Andrea.

Ms. CORCORAN. We have done reports on all of the exchanges—I mean nine of the exchanges, and we have two left to go: Coffee, Sugar and Cocoa, and the New York Futures Exchange. And with respect to each of those exchanges, we have inquired as to and developed figures as to the accuracy that they are achieving now.

I frankly would have to go back and look at those reports to see which exchange has the most accurate timing at this point in time. But all of the exchanges are in excess of 85 percent that we have reviewed.

Now, the rule itself is a 100 percent compliance rule. I mean, the point is that there has to be some practicality in the way you apply such a rule. What we have done is attempt to push each of the exchanges in the direction of making those changes that would improve their accuracy level and improve their ability to verify.

I would point out that the audit trail you have now is light years ahead of what we had prior to 1986. It can be used to reconstruct trading. It was used in the market break by the SEC and the Brady Commission to reconstruct trading. And it can be used to research offenses very effectively, but it can be improved from a detection point of view. And the Commission has moved very aggressively in that direction.

Mr. COLEMAN. OK. So you have a rule now that requires 100 percent accuracy which no one has yet met?

Ms. **Corcoran**. That is right.

Mr. **Coleman**. But someone has hit 95. I understand the Chicago Mercantile and the Board of Trade have 88 or 89 percent accuracy. We will hear from them Thursday.

Dr. **Gramm**. I would also point out that those were rule enforcement reviews of an earlier period, and in some of them, we have asked them to make further changes.

Mr. **Coleman**. So what is the incentive, what do you do to tell them we want you to hit 91 next year and 95 in 2 years or something? What is it that is going to move them?

Dr. **Gramm**. If we were to set a schedule or make a determination that we want to have another standard or a different standard, or if we felt that an exchange was not meeting the current standards that we had set, there are a number of things that we could do, the least of which——

Mr. **Coleman**. Current standard is 100 percent, and no one is meeting that.

Dr. **Gramm**. In terms of—well, from our perspective, there are still a number of things that can be done if we felt that the exchange was not meeting its affirmative responsibility for compliance and for carrying out all the rules of the Commission, from bringing a lawsuit to not approving contracts, to disapproving contracts that are already——

Mr. **Coleman**. All right. There are things that you can do.

Dr. **Gramm**. Absolutely.

Mr. **Coleman**. But this gap between 100 percent and whatever it may be for an exchange today, those threats are possible, and that would move them up. And maybe you will or will not take that position.

Now, I know I am running over my time, but this is an important point. In the legislation, we have prohibited dual trading with certain exceptions—7,000 contracts, et cetera—but also flexibility to you, the Commission, to issue orders to exempt exchanges from this limitation, if you can detect any and all instances of trading violations which the Commission determines to be attributable to dual trading and is fully verifiable. How do you interpret that language?

Dr. **Gramm**. That there could not ever be one instance of a violation that occurred in the markets. I think that that standard is so high that it could not be met.

Mr. **Coleman**. All right. What is the difference between that and your 100-percent rule?

Dr. **Gramm**. The 100-percent standard is a standard that one has as a target. Now, whether or not one wants to require 100-percent verification of 100-percent competence level——

Mr. **Coleman**. Well, 100 percent is 100 percent.

Dr. **Gramm**. Probably may well not be cost effective. I mean, that is one of the things that we are reviewing right now since we have gone to our first round of enforcement reviews.

Mr. **Tallon**. Would the gentleman yield?

Mr. **Coleman**. Well, now, let me ask this: Your 100 percent is a goal, and it has not been attained, may never be attained, I gather, under current technology.

Dr. **Gramm**. The Commission may decide that it may not be attainable or that it is wise to——

Mr. **Coleman**. You may withdraw that rule and put one in that says 95 percent.

Dr. **Gramm**. We could.

Mr. **Coleman**. OK. Now, do you——

Mr. **Tallon**. Would the gentleman yield?

Mr. **Coleman**. Let me go ahead and ask a question.

Now, do you think that we need to have some language different from "any and all instances," which in my book is 100 percent? Do you think that we are pushing——

Dr. **Gramm**. I think that that standard is an extraordinarily high standard that—as a matter of fact, the point I made earlier is that when you use record surveillance to monitor markets, there are some things that might not be caught by the records.

That standard is extraordinarily high, "any and all." One of the reasons it is very useful to us is to determine the extent to which there are abuses or may be abuses that occur which records may not be sufficient to catch.

And don't forget that the abuse of the dual trading privilege is typically the trading ahead of the customer, and that is trading ahead of a customer's account when you have an executable order in your hand, so there is other information that must be available as well in order to bring a case.

Mr. **Coleman**. And detection itself would require 100 percent instances——

Dr. **Gramm**. No, not necessarily. I think the way the Commission looks at it is that what is most important is the sequence of the trades; the trade reconstruction capability is really what is most important.

Mr. **Coleman**. I know my time has run over, but this language is strict and it is strong, and we will hear more about it. And it may be that what we want to accomplish for dual trading—once that audit trail is in place—we may see we have a standard here that is too high to be met, or it may not be. I want to hear from the witnesses about that. And you are telling us as a witness that it cannot be met.

Dr. **Gramm**. In my view, that's true. And furthermore, how would we ever know—I mean, even with undercover operations, there might be a time when there could be abuse that occurs, particularly if there is abuse, for example, with an accommodating broker where there might be——

Mr. **English**. Why don't you provide us with what you think is absolutely the very maximum that we could expect in a standard, and then we'll take a look at that.

Ms. Long.

Ms. **Long**. Thank you, Mr. Chairman.

Dr. Gramm, you advocate self-regulation. I have a question. If you found in the soybean investigation that there was a conflict of interest of the Board members regarding the soybean contracts, what would that say to you about self-regulation? I'm not saying that is going to happen, but if you found that, what would your conclusion about self-regulation be at that point? Would it change?

Dr. GRAMM. I think it depends on what happens in response. If, for example, there were a particular problem, I want to see what the exchange did about that problem—did the exchange bring a case? One of the things that we do in our review of the exchange is to look at how well they monitor their own adherence to their own rules and regulations.

And again, I should point out that this self-regulation is not anything—well, it is certainly not like what I thought about self-regulation earlier on, and that is that we have a tremendous amount of oversight, but the important part about self-regulation that is different, I think, than in other areas is that the exchanges have the responsibility to carry out their activities and to carry out the Commodity Exchange Act.

So not only does self-regulation try to rely on the competitiveness between the exchanges to do the best job—obviously, their ability to stay in business has something to do with their making sure that the customers and the users are satisfied and have confidence in the market. OK, that's reinforced. But what this act does, which I think is different, is that it gives them also the affirmative responsibility, with us standing there with an awful lot of authority and power to not approve their contracts, basically to countermand anything they might want to do.

There is an awful lot of authority, and I think the Commission has over the years been very mindful of that authority, and we would not want to abuse it, either.

But the fact of the matter is that the exchanges have the flexibility and the ability to move faster than Government agencies typically do. Nevertheless, the Commission is always ready to bring enforcement action on its own, including enforcement action against an exchange, if we think they are not carrying out their responsibility.

Ms. LONG. Let me ask you about emergency action. We know what happened to the markets, and we know how the drop in prices affected farmers last week when the Chicago Board of Trade took emergency action.

In your judgment, do you think that before rather than after, before an exchange takes emergency action, they should notify you rather than waiting until afterward?

Dr. GRAMM. I haven't identified yet any problem in the process of notification. As a matter of fact, the exchanges typically have notified me before in areas where they don't have to—in margin changes, et cetera—and I have not as yet identified a problem. But again, bear in mind that we will be reviewing all of this in terms of the process and notification just hasn't been a problem.

Ms. LONG. But pragmatically, given that you have the authority to order them not to take the specific emergency action that they might be planning, I guess I have a disagreement with you. It seems to me that you can be a much less biased, much more objective body to determine what kind of emergency action——

Dr. GRAMM. I think one of the things—and again, it is something that I will maybe want to think about and visit with my fellow commissioners about—you have to remember that when you are dealing with an emergency, typically, there are things that are occurring minute by minute. Commission action requires a majority vote of the Commission. We are, under the Government in the Sunshine Act, to wire and notify people of a meeting 7 days in advance, even for a closed meeting. I think the way the system is working now, we haven't found any problems in the process itself because we monitor these markets very carefully ourselves, and it is an interactive relationship not only with the exchanges but also with participants in the markets, to ensure the orderly liquidation. That is critically important if these markets are going to have the kind of public confidence that they have had over the years.

So I haven't identified a problem there yet, and what we don't want to unwittingly do is to reduce the ability of exchanges to take quick action if they determine they need to—again bearing in mind that we are always there to second-guess. They also have to consider the impact on their participants and how irritated their participants would be as well.

But again, it is something that I'll think some more about and certainly it is an issue—the whole emergency action issue—that will be reviewed in due course.

Ms. LONG. Thank you.

Mr. ENGLISH. Mr. Tallon.

Mr. TALLON. Mr. Chairman, thank you.

Dr. Gramm, if we were to totally ban dual trading, it would very likely have an adverse impact on the liquidity of the futures markets in this country, would it not—yes, ma'am?

Dr. GRAMM. If banned, it may well have. Again, that is one of the areas that we are looking at empirically——

Mr. TALLON. I know, we are waiting on the October study, and I guess there is no way to get it before October. It is just pretty obvious to me, and it should be to anybody else, that certainly, if we have a total ban on dual trading that it would adversely impact the liquidity of markets in this country, futures markets.

Dr. GRAMM. That certainly is what we have been told.

Mr. TALLON. Dr. Gramm, what about foreign markets that compete with our markets here—what kind of restrictions do they have on dual trading? Is it true that they have no restrictions on dual trading?

Dr. GRAMM. Let me turn to Andrea. In the London markets, they allow dual trading. Do you know with respect to the other markets?

Ms. CORCORAN. We have not made a survey of the foreign markets, but I would frankly be surprised if many foreign markets have restrictions on dual trading. After all, it is only recently that foreign countries have restrictions on insider trading at all in the securities markets——

Mr. TALLON. If you could provide that information for me, I think it would be very helpful in light of the legislation that we're looking at here and the restrictions that we are going to put in, because it would seem to me if there is no ban on trading in foreign markets, and if it would have a negative impact on the liquidity in our markets, we would certainly stand, Ms. Gramm, to lose business to foreign markets, would we not?

Dr. GRAMM. Yes.

Mr. TALLON. Thank you very much.

[The information follows:]

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OFFICE OF
THE CHAIRMAN

August 15, 1989

The Honorable Glenn English
Chairman
Subcommittee on Conservation,
Credit and Rural Development
Committee on Agriculture
United States House of Representatives
1301 Longworth House Office Building
Washington, D.C. 20515

Dear Chairman English:

During my testimony on Tuesday, July 18, 1989 before your subcommittee, you inquired whether foreign jurisdictions permit or prohibit the practice of dual trading on commodity markets in their jurisdictions.

I am pleased to supplement my response on this issue with information related to the status of dual trading in Australia, France, Japan, Ontario, Quebec and the United Kingdom. Specifically, information collected by the Commodity Futures Trading Commission ("Commission") on the practice of dual trading on major commodity markets in the above-referenced jurisdictions indicates that dual trading is permitted on such markets. However, as far as the Commission can ascertain, most jurisdictions also impose restrictions similar to those imposed by the Commission on such practice. For example, the laws in effect in the United Kingdom require that in executing trades, firms must subordinate their interests to those of their customers.

I appreciate this opportunity to supplement the record and would be happy to discuss further any aspect of this issue at your convenience.

Very truly yours,

Wendy

Wendy L. Gramm
Chairman

Mr. TALLON. Ms. Gramm, it is obvious that we are not going to maintain the status quo. We need to have some standards for an improved audit trail to get at the real problem here, which is not dual trading; it is "front-running" or trading ahead of the customer. I would think that the CFTC would be in the best position to come to this committee—I know the exchanges in New York and Chicago are different; I know they have their inherent differences—but to make recommendations to this committee so we don't negatively impact on the efficiency of these markets. I think that is the greatest service you could provide this committee at this time. I am speaking for myself, but that is certainly something that I wish you would consider.

Dr. GRAMM. We will certainly try to do the best we can, because I do think it is important that the committee get the best and the most information possible. You share some of my concerns.

Mr. TALLON. If the CFTC could address that right away, I think the whole committee would like to see it—whether they agreed with it or not, I think it would be very helpful.

Finally, does the bill that has been introduced give the CFTC all the necessary flexibility to avoid any possible negative effects of a dual trading ban on markets?

Dr. GRAMM. No, it does not as it is currently drafted.

Mr. TALLON. Thank you.

Mr. COLEMAN. Wait just 1 minute.

Mr. ENGLISH. Let me go over that a little bit. I believe you want to reconsider that answer, don't you, Dr. Gramm?

Mr. TALLON. Let me ask the question again. I'm sorry. Does the bill give the CFTC all the necessary flexibility to avoid any possible negative effects of a dual trading ban on markets—of course——

Mr. ENGLISH. Are you going to answer for her, or do you want her to answer?

Dr. GRAMM. We'd have to review that pretty carefully, but we do have the concern that it does not——

Mr. ENGLISH. Let's go through that very carefully, then, Dr. Gramm, so that there is no question with regard to this issue.

With regard to the legislation——

Mr. TALLON. I yield to the chairman.

Mr. ENGLISH. I appreciate the gentleman yielding. [Laughter.]

He has had the gavel over there all day, trying to play chairman, so I'll take it back.

The point that I am trying to make, though, is under the legislation as it stands, any contract that trades on an average, 6-month average, of less than 7,000 contracts per day is exempt unless the CFTC determines that in fact it would not affect liquidity, it would not have an impact, and they can impose less than 7,000 contracts—correct?

Dr. GRAMM. Yes.

Mr. ENGLISH. Well, maybe to speed it up, I'll just go through it, and then we'll see if there is any question with regard to it.

Dr. GRAMM. OK.

Mr. ENGLISH. It also maintains that for any contracts that would go over that 7,000 at any particular point, or transition—there is a transition that is allowed for the CFTC—it also allows for the provision that should in fact we find it is an aberration, the CFTC determines it is an aberration, they are not required to impose a ban on dual trading. Should the CFTC determine that in fact this does have a negative impact—and I don't have the exact words in front of me; there are about three different provisions, which are extremely broad and extremely generous—which in effect says that should the CFTC determine on any of these contracts that it would have this kind of negative impact that the CFTC does not have to impose a ban on dual trading.

That's an awful lot of leeway—in fact, we're probably going to get some criticism that it is a very big loophole.

Dr. GRAMM. Well, I guess—and again, it is something that——

Mr. ENGLISH. Is it true that you do have that flexibility in the legislation?

Dr. GRAMM. We do have flexibility. The bill gives us flexibility. However, I do question——

Mr. ENGLISH. Is there anything here—let me just ask you, and we'll cut through all this—is there any danger that you can perceive of, any threat or any danger in which the CFTC under this legislation would not have the authority to suspend a ban on dual trading?

Dr. GRAMM. To suspend—wait, now——

Mr. ENGLISH. Is there anything negative that you can perceive, any kind of danger that comes up that CFTC would not have the authority to act?

Dr. GRAMM. What about GLOBEX, for example, where you don't know who is on the other side of a particular trade, and basically, since you don't know who is on the other side——

Mr. ENGLISH. I'm just asking you—I'm asking the questions—the question is can you come up with anything, any particular kind of instance, in which this is in any way going to threaten a contract.

Dr. GRAMM. Well, I'll use the new GLOBEX screen trading system as an example—if you don't know who is going to be on the other side of a particular trade, how would this particular bill——

Mr. ENGLISH. The whole point, though, Dr. Gramm, that we are getting at here, and the question that Mr. Tallon was pointing to, is a threat to the contract. You know, I'm not asking you with regard to your detection; that's up to you all. You all are the experts, and you all ought to be able to detect whether dual trading is taking place or not. The point that I am coming down to is can you come up with a single instance in which this would threaten a contract that is not covered under the provisions of this bill.

Dr. GRAMM. That would threaten a contract—in the sense that in order to remove the ban on a particular contract——

Mr. ENGLISH. I'm not talking about removing the ban. I'm asking you can you come up—the whole point that we came down to on this, Dr. Gramm, is this question: Does this in any way threaten a contract, from the standpoint do you not have all the authority that you would need that if in any way a contract is threatened by this action of banning dual trading, that you could not impose dual trading?

Dr. GRAMM. The problem is that the standard is that if the prohibition would create undesirable price volatility—unacceptable widening of the bid-ask spread, for example——

Mr. ENGLISH. And?

Dr. Gramm. And it seems to me that that is something that may well be in litigation. Those are, again, difficult judgment terms.

Mr. English. Well, then, why don't you just say, "No, I cannot come up with anything," because that's what you're saying.

Dr. Gramm. Isn't that an example——

Mr. English. I don't think so.

Dr. Gramm. Where, if the issue is the empirical proof that this is unacceptable price volatility, caused by the dual trading ban——

Mr. English. That's a judgment call. We're giving you that judgment, Dr. Gramm. We're giving you that judgment. That's for your determination, that's for your judgment call. And all I'm saying is you've got——

Dr. Gramm. But those terms would come out in litigation as to whether or not it is unacceptable price volatility due to the dual trading ban, which would be very—it is a difficult standard. It is difficult in terms of the evidence that would be required—again, these are somewhat more technical issues of how this would be carried out. And therefore, I have some real concerns about how we would implement it. While the bill on its face gives some flexibility there, I have some concerns about how would you actually implement it, even given these ways that we can opt out or allow dual trading. Determining, for example, the amount of acceptable or unacceptable price volatility or liquidity in a market is very difficult. And determining how much price volatility or lack of market liquidity is due to the dual trading ban is a very difficult empirical issue. I mean, this might be the economists' employment act of 1989, and I would again hesitate——

Mr. English. Let me say, Dr. Gramm—come on, let's drop the sham here—you are opposed to any kind of ban on dual trading.

Dr. Gramm. That's not so at all. I really do have an open mind on this——

Mr. English. Let me go ahead and finish my statement. To me it has become very clear that's what your position is. I don't know of any Government body—I don't know of any regulatory agency—when you take those three provisions that are contained in that law, that couldn't take it and do just about anything they want to with it. If there is criticism of it, there probably should be strong criticism that it needs to be tightened up. We are trying to provide the maximum amount of flexibility.

Now, there is one point, and I would certainly agree to this, and that is that whenever the CFTC takes this action, they are going to have to come up before this subcommittee and justify that action. And I would certainly hope that should the CFTC exercise any one of these provisions that they would be prepared to do that; I would hope that you in effect would be able to back up the stance that you've taken. That's basically what this provision has done.

But to try to tell us what the language that is in that legislation—my goodness, there isn't a bureaucrat in this town worth his salt that couldn't take that and do just about anything they want to—but the one provision is that you'll have to come up and justify it before this subcommittee.

Dr. Gramm. I am sure that we could pass a rule on anything that would implement the Commodity Exchange Act. The question was, do I think we have the sufficient flexibility here. I should point out——

Mr. ENGLISH. No, that wasn't the question. That was not the question. I asked you if you could come up with any specific examples in which——

Dr. GRAMM. Oh, that was the second question, the follow-up question.

Mr. ENGLISH. That would in any way threaten any contract that is available, and you haven't.

Dr. GRAMM. Again, I think those are issues—as I said earlier in my testimony, the Commission is taking a broad brush look at this, but there are some very difficult technical questions about this particular bill that I would like to review.

Now, on your statement that I am opposed to a ban on dual trading, I don't think that is correct. I have not come from any perspective except one of looking at the issue using the best information that we can have which includes for the first time information that we will have off the audit trail; it may include additional information from the Justice Department. And I have not in my mind made up any position with respect to dual trading or being opposed to the ban on dual trading.

Mr. ENGLISH. Mr. Nagle.

Mr. NAGLE. Hi. See, I'm the nice guy here. [Laughter.]

Let me ask you something else, if I can.

Mr. Smith was here before you—I think you were in the room—and he mentioned something that I wanted to make inquiry about. In his testimony, he said:

> The law as it has been developed under our various securities statutes is based on the unfairness of allowing traders to profit from their own accounts with the use of information not available to others in the marketplace. The same type of activity that securities law prohibits is not illegal in futures trading, and the acts for which people are being prosecuted in New York would not be illegal in futures.

Is there a ban on insider trading in the futures markets?

Dr. GRAMM. No, but there are a number of practices which are unlawful by either rule or regulation that could be considered insider trading for the futures markets. For example, trading ahead of one's customer——

Mr. NAGLE. No, no, we're not talking about that. Let me go further.

> An official of the futures exchange, an account executive, a floor broker, or even the backroom staff of a futures commission merchant, could use nonpublic information regarding a large, reportable position in futures contract of his customers where the anticipated transaction leads to profit in their own account.

Dr. GRAMM. This is in the futures exchange——

Mr. NAGLE. Yes.

Dr. GRAMM. Of a futures exchange.

Mr. NAGLE. All right. Well, there are two rules that I think are worth mentioning. One is that there is a Commission regulation that says employees of an exchange may not disclose or use nonpublic material or nonpublic information. Furthermore, we have required all exchanges to have regulations that would prohibit members from using material, nonpublic information, that they obtain in the course of their serving on various boards and committees of members.

Let me pursue this——

Dr. **Gramm**. So that would be covered.

Mr. **Nagle**. Now, if I were a trader, and I got wind of the fact that CBOT was going to meet and discuss a possible liquidation sale in the futures market in soybeans for July, and I got that at 2 o'clock, and the Commission took its afternoon at 3 o'clock, would that be an "illegal" activity by CFTC regulation?

Dr. **Gramm**. Are you saying that someone picked up a rumor that there might be a meeting?

Mr. **Nagle**. Well, a rumor based on good—there are good rumors and bad rumors. Suppose I picked up a good rumor.

Dr. **Gramm**. Well, rumors would not be illegal. Now, if a board member disclosed information that is material nonpublic information, that would be a violation of that regulation. But rumors abound in all markets, on the securities side as well.

Mr. **Nagle**. Well, let me just ask you this, then. I don't mean this in terms of hostility, but I think maybe Mr. Smith raised a good point when he was here. Is there anybody that favors permitting trading on inside information?

Dr. **Gramm**. Well, if I am a large cotton farmer, and I know I am going to bring a certain number of bales of cotton to market, and I use that information myself to hedge on the futures market, that is hedging, and that is really a function of the futures market——

Mr. **Nagle**. I understand.

Dr. **Gramm**. We wouldn't consider that insider trading, but in some sense we have to be careful.

Mr. **Nagle**. I mean the type of inside information that is prohibited in the securities market; is that permitted in the futures market?

Dr. **Gramm**. Again, insider trading in the securities markets refers to nonpublic information about a company, about actions that a company may take and the impact on the price of their stock—their individual stock, which is a little different. So we can't just transpose from the securities markets into the futures markets.

However, I would point out that there are a number of insider trading-like prohibitions and rules that are already unlawful, either through rule or regulation or through the customer abuse aspects of this act.

The one area, I think, where Congressman Smith pointed out—I think there was one area where there aren't rules—and that covers the employees of a company, a private company, and whether or not that employee would use that material, nonpublic information, of an impending action of a private company.

Now, we would argue that if that person had a responsibility, for example, for trading for that company and used that information, that that would violate their fiduciary responsibility to the company, and therefore would be a violation under our rules.

However, if it is, say, just somebody who works for the company who may learn that the company or know that the company may be bringing a certain amount to market, and therefore trades, using that information, trades on the market, that would not be covered by our act.

Mr. NAGLE. My time is out, and I want to move along, but could I ask you to do this—would you, before the end of the week, please review Mr. Smith's bill, H.R. 603——

Dr. GRAMM. Yes, we would be happy to.

Mr. NAGLE. And respond as to the CFTC's reaction to that. I don't mean this in any antagonism, but I don't think anybody approves of prohibited insider trading practices or inside information practices, and I think that if we have to strengthen it to ensure the sanctity of the market, it is a proper step that we all ought to join in, and maybe we all ought to join Mr. Smith where we can in doing that. But I would be interested in your reaction to it, and I know you did not know I was going to ask you this morning, so why don't you study it and get back to me?

Dr. GRAMM. Absolutely, we'd be happy to.

Mr. NAGLE. Thank you very much.

Mr. ENGLISH. Mr. Penny.

Mr. PENNY. Thank you, Mr. Chairman.

Let me go to soybeans. You indicated that you saw for several weeks this crisis, if we can call it that, developing in which there was a monopoly in terms of one firm holding a high percent of those soybean futures.

Didn't you also testify that you were in regular contact with the Chicago Board of Trade about that impending problem?

Dr. GRAMM. Yes. May I make a prefatory comment? There have been a number of statements by members about what we saw or what our position was, and I want to be very careful. It is like what I do to reporters sometimes when they say, "Do you mean this?" I would just like to be sure that what I say about the markets, in fact, that we are concerned, and we monitor these markets—that is what I mean—and that I haven't necessarily come to conclusions as to the existence or nonexistence of other specific problems in markets.

Mr. PENNY. But you saw the situation developing.

Dr. GRAMM. We saw a situation developing where we had surveillance concerns about the orderly liquidation.

Mr. PENNY. And you talked on a regular basis with the Chicago Board of Trade about this development?

Dr. GRAMM. We share information, yes.

Mr. PENNY. One of your roles is to assure orderly liquidation in the market. Wouldn't it have been more orderly for some decision to have been made earlier about liquidating those contracts so that it could have occurred over a longer period of time, leading up to the July 20 deadline?

Dr. GRAMM. Let me speak more generally, rather than the specific case, which again, we are going to be reviewing. But again, the market emergency or congestion at the liquidation doesn't necessarily occur 2 weeks out. You can see a problem occurring, but if the people with large, concentrated positions begin to liquidate, then you won't necessarily have a problem.

Dave, would you like to expand on that?

Mr. KASS. Yes. It has been mentioned that we have monitored this for several weeks, but obviously, there are always opportunities for the situation to resolve itself, either through availability of additional soybeans—for example, this year we had a limit up move with a weather scare in early July and made more soybeans available, and farmers sold more. Now, if that had continued at a higher price level, perhaps the farmers would have sold more.

In addition, there is the Brazilian situation and many labor problems that have stymied the export of that crop, and producers have gone on strike. Now, if that had resolved itself, it may also have made other soybeans available to satisfy needs in the markets. And that is a day to day, hour to hour thing that you monitor. We are in contact with all the major traders. If there are longs, we are asking about intentions to take delivery, what are they securing in the physical markets to meet their needs. If there are shorts, we are asking about their abilities to make delivery and what are they doing to secure supplies in the physical market; what about ownership. We do have broad inspection powers under the law that we do examine routinely in instances of concerns, specific contracts of commitment—if a trader tells us he or she has processing needs, we will examine his or her weekly/daily processing capacities and how they have been utilizing that.

We examine specific export sales—what is the quantity, what are the shipping dates, when do they need these, what ports are they going to ship out of, what types of soybeans, and what efforts they have made to acquire those soybeans——

Mr. PENNY. Are all those pieces of information things you are looking at? I know you don't want to be specific, but as this whole thing was developing, were you looking at all these other factors as well to determine whether there was a legitimate reason for certain firms to be acquiring——

Dr. GRAMM. Absolutely.

Mr. KASS. Without fail, any time any market—if a long, for example, says we need May corn, July soybeans, whatever it might be, and we must take July deliveries because of our immediate pressing need for processing exports, whatever it might be, we generally ask for verification in terms of photocopies of export contracts, records of processing requirements they have been using; and on the other hand, shorts, if they indicate that they have hedges against this, against the inventory, or they have the wherewithal to acquire the corn or soybeans, we examine those capabilities as well.

Mr. PENNY. Are you free to say whether you were satisfied with the information about the need of this firm to acquire that volume?

Mr. KASS. First of all, we haven't confirmed or denied any specific firm being involved in this. There obviously is a matter of some court record of one particular firm having certain positions which were revealed through a court record in Chicago last Thursday. But we obviously cannot comment on an ongoing market situation.

Mr. PENNY. What might have been the market reaction if a liquidation order had been signaled—if, by such-and-such a date, this trend continues, we will force a liquidation—would it have the exact same effect, only 3, 4 days earlier, or 1-week earlier?

Mr. KASS. I don't think you can prejudge that. I was around when we took the Hunts to court in soybeans in 1977, and on a day-to-day basis as we were in District Court, as the testimony was coming out, soybean prices were going up or down depending upon who looked like they were going to be successful——

Mr. **Penny**. So instead of waiting until last Thursday, I guess, if a week and a half or 2 weeks earlier, we had said, look, we are approaching July 20, and on July 12 or 13, we are going to take this action if things don't correct themselves by then, that wouldn't necessarily have resulted in a more orderly kind of exchange?

Mr. **Kass**. I think I would like to leave open the possibility that those sorts of things were being done.

Mr. **Penny**. Do you think that they were being done in this case, that the signal was being sent?

Mr. **Kass**. I cannot comment on this case, but it would not be unusual for us to take actions with individual traders.

Mr. **Penny**. Does the CFTC have the authority to step in and dictate to a board that that——

Dr. **Gramm**. We can take the action ourselves.

Mr. **Penny**. But you generally choose not to——

Dr. **Gramm**. No, that's not true.

Mr. **Penny**. You generally choose to kind of talk back and forth and let the board decide how to handle it and then review it afterwards to see if they did the right thing?

Mr. **Kass**. Without commenting on July soybeans, we often take actions, and we may have in this case, that don't make the press. We don't like to become a market factor.

Mr. **Penny**. You are neither confirming nor denying that you took action on this prior to last Thursday?

Mr. **Kass**. It is not unusual for us to take actions in terms of cautioning traders, warning traders formally, in terms of curbs and restrictions on their hedging capabilities and things like that in past liquidations. Now, whether we have done those things already, or contemplate that in this liquidation, we're not going to comment.

Mr. **Penny**. Thank you, Mr. Chairman.

Mr. **English**. Thank you very much, Mr. Penny. I appreciate it. I think we'll recess, and our next witness will be Mr. John Damgard, FIA.

Let me also say, Dr. Gramm, before you leave, there is certain information that we requested last week, and it is my understanding that will be provided to us on Friday; is that correct?

Dr. **Gramm**. I'd like to discuss that with you further, as I indicated yesterday. I have some concerns about information that is confidential, market-specific information.

Mr. **English**. Well, it is my understanding that we had reached an agreement, or at least my staff in talking to your staff had reached this agreement last Friday that we would not. So you are telling us you have not agreed to give us that information?

Dr. **Gramm**. No. I believe that what the discussion with staff ultimately was was that we would have to discuss that, the principles, meaning——

Mr. **English**. Well, let me state very clearly this subcommittee intends to obtain that information. And if I need to take it up with the other subcommittee members, I will.

Dr. **Gramm**. I appreciate your expression of that view. I would like to spend some time discussing that a little further.

Thank you.

Mr. **English**. We will recess until 2:30.

[Whereupon, at 1:40 p.m., the subcommittee was recessed, to reconvene at 2:30 p.m. this same day.]

AFTERNOON SESSION

Mr. ENGLISH. The hearing will come to order.

This afternoon our first witness will be Mr. John Damgard who is president of the Futures Industry Association here in Washington, DC.

John, we want to welcome you here and we would be happy to receive your testimony.

I might remind our witnesses that perhaps either were not here this morning or maybe forgot, that without objection your full written testimony will be made a part of the record, so feel free to summarize and any of you that have planes might want to summarize even more than the summary, I do not know.

STATEMENT OF JOHN M. DAMGARD, PRESIDENT, FUTURES INDUSTRY ASSOCIATION

Mr. DAMGARD. I am pleased to do that, Mr. Chairman. I am delighted to be here, and I will submit my whole statement for the record. I would like very much to touch on the parts that the FIA feels are the most important.

Mr. Chairman and members of the subcommittee, my name is John Damgard, and I am here today in my capacity as president of the Futures Industry Association. Thank you very much for the opportunity to appear before you today on behalf of the members of the FIA.

The FIA is the national trade association of the commodity futures and option trading industry. Our regular membership is comprised of more than 100 of the largest futures brokerage firms, known as "futures commission merchants" or "FCM's." They handle more than 80 percent of the transactions on the U.S. futures exchanges.

At the FIA, our primary concern is to protect the interests of those who use and benefit from our markets. Today, the FIA is pleased to offer its support of H.R. 2869. Congressmen English, Coleman, and Penny have introduced a bill that the FCM community believes can be the basis for reforms that will usher futures trading into the 21st century.

We share the view embodied in the legislation that an improved audit trail is the key to these reforms. An audit trail that can be verified and that accurately reconstructs the sequence of trading in a timely manner has been the goal of the U.S. futures community for the entire 14 years of the CFTC's existence.

In 1974, the House Committee drafted amendments to the Commodity Exchange Act which established a system of self-regulation in the industry, accompanied by active oversight from the newly-created CFTC.

The premise of the Commodity Exchange Act is that the exchanges will police themselves and that the CFTC will review the efficacy of these efforts. It has long been the view of the FIA that without a verifiable audit trail, which accurately accounts for every trade, the exchanges, the CFTC, and indeed Congress itself lack the tools necessary to assure the public that the markets are free from abuse.

We believe that until a verifiable audit trail is in place in every exchange, the futures industry, the CFTC and Congress will be vulnerable to public criticism and skepticism—no matter how well founded—about the integrity of the system.

The exchanges have made tremendous advances in their audit trail systems during the last few years. That progress can be seen both in the CFTC rule enforcement reviews—highlighted in a recent report by your subcommittee's inquiry team—as well as in the sustained growth in the volume of futures trading. But there is more work to do and sometimes the last mile is the most difficult to traverse.

The bill under consideration today requires that the exchanges refine their audit trails within a stated timeframe. Namely:

First, after the first year the legislation has been in effect, the exchanges must provide the verifiable time of execution for every futures or options trade in increments no greater than 1 minute.

Second, no later than 3 years from the effective date of the legislation, the exchanges must refine their audit trails to increments of no more than 30 seconds.

The FIA strongly supports these amendments to section 4(g)(2) of the act. We believe, however, that analyzing the audit trail's efficacy and exploring new technologies to achieve optimal enforcement of the CEA are paramount. This work should be ongoing, and Congress should request yearly reports on its progress.

The subcommittee has indicated its belief that existing audit trails may not detect some trading abuses which accompany dual trading. The subcommittee therefore proposes limiting a broker's ability to engage in dual trading, except in special situations, where an average volume of over 7,000 contracts are traded daily.

The only exclusion is a case where the exchange's audit trail can detect any and all instances of trading violations that the CFTC determines to be attributable to dual trading and where the audit trail is fully verifiable.

A recent Chicago Mercantile Exchange special committee report addressed the public confidence issue that can accompany dual trading. As the report said:

> . . . it has become painfully evident that the public image of futures markets and their members has been adversely impacted by the widely-held belief that dual trading in futures leads to customer abuses.

The CME's special committee suggested that that exchange ban dual trading and in mature, liquid markets. This would affect about 80 percent of all transactions on the CME.

Thus, both Congress and the special committee recognized that while some abuses may accompany dual trading, banning it altogether might adversely affect the less liquid markets. The FIA has supported this view with the important caveat that whenever dual trading is permitted, there should be adequate safeguards in place to assure the integrity of the market.

An audit trail system that detects abuses and an exchange that will take actions against those who abuse the system provide such safeguards.

FIA, therefore, believes that H.R. 2869 correctly links dual trading to a more precise audit trail. It is difficult, however, for Congress to legislate whether certain markets are sufficiently liquid or whether they require the liquidity afforded by dual trading.

We would prefer that the Congress direct the CFTC to review the efficacy of such a liquidity test. In particular, we believe there may be other considerations—quite apart from how many contracts are traded—in determining what is an active, liquid market.

Moreover, since the CFTC reviews and monitors the performance of audit trail systems, the CFTC is in a better position to assess the system's ability to detect and prosecute trading abuses.

The CFTC currently is addressing dual trading and has promised a report on economic and other aspects of this issue by September. We respectfully suggest that it is in the best interests of the customers and the industry alike to take a closer look at the CFTC's study and others underway before acting definitively on dual trading.

Telemarketing fraud: The subcommittee's inquiry team has focused on the solicitation by a few firms of persons who, unaware of the risks of trading futures and options, are enticed to become customers through high-pressure sales solicitations.

The FIA understands the subcommittee's concern with high pressure sales. Individuals and firms who use such tactics to defraud customers do not belong in the industry, and we support all efforts to remove them.

We are concerned, however, that the language the subcommittee is proposing will result more in frustrating the legitimate users of futures and options than eliminating the bad apples. The regulators will have difficulty in determining what is a first-time sales solicitation and the firms will have a next to impossible time supervising for compliance with the rules.

Some of our large firms have told us that they would be forced to hold all customer trades for 3 days because of the supervisory problems related to the compliance.

Unlike others in the financial services arena, futures professionals already provide specific risk disclosure statements to all futures and options contracts, and these disclosures must be acknowledged and returned before a firm may take a customer's trade.

In most cases this procedure alone would provide customers with a cooling off period. Futures professionals must comply with NFA rules which regulate the content of all communications between NFA members and the public. These rules specifically prohibit fraud, deceit and high pressure sales practices.

It was noted during the recent subcommittee hearings that the NFA program to answer ads and pose as potential customers is an effective way to discover high pressure tactics and take action. This system should be enlarged and adopted by other industry self-regulatory organizations that have a responsibility in this area, and we believe it will.

The FIA would like to continue to work with the subcommittee to help it fashion a proposal that is appropriately directed at those persons and firms on the periphery of the industry who are using unlawful sales techniques.

Undercover operations: The FIA supports the legal application of such undercover procedures. On governing boards and disciplinary committees, the FIA supports the requirement that disciplinary committees be composed of persons who are of a different trading status from the respondent.

This requirement appears to be reasonable with the additional proviso that an exchange be able to put nonexchange members on such panels in special cases.

Whether governing boards should be comprised of at 20 percent public members has already been decided by several exchanges which have opened their boards to have more outside members. Our only caveat is that public members should be expected to have a working knowledge of futures markets.

The FIA has also been concerned about increasing the actual representation of nonfloor interests on exchange boards. To that end, we have asked the Congress and the CFTC to encourage exchanges to have broad representation on their boards.

Registration requirements: It is in everyone's best interests to keep persons with questionable backgrounds from entering the industry, and we support strongly what is in the legislation.

Registration of floor traders: We fully support its enactment.

With respect to ethics, we fully support the efforts to increase industry registrants' knowledge of and sensitivity to ethical considerations involved in soliciting and handling customers' accounts and trading in futures markets, whether for customers or for proprietary accounts.

Whether the "sunset" of the CFTC is a real or perceived problem, the FIA believes Congress should take every step necessary to give the Commission permanent status. We support the appropriations figures for 1990 and 1991 and commend the subcommittee's actions to eliminate any uncertainties in the Commission's future.

The CFTC should have permanent status, similar to the Securities and Exchange Commission, because it will provide for stability and continuity of regulatory leadership.

We can also support all of the CFTC proposals as discussed by Chairman Gramm earlier. I would add this caveat to my testimony. The specific language of all of H.R. 2869 warrants closer review than was possible during the time we were given to prepare this testimony.

Therefore, we ask the subcommittee's permission to submit additional comments and suggestions for the record should we feel that to be necessary.

Thank you very much and I am pleased to answer any questions.

[The prepared statement of Mr. Damgard appears at the conclusion of the hearing.]

Mr. ENGLISH. Thank you very much, John. I appreciate your testimony and let me say also that, at least speaking for this member, I appreciate the attitude of the FIA. I think that certainly with your testimony, you have struck the right note.

It is a question of whether we are going to raise the standards and how we can best obtain those standards. I appreciate your attitude and FIA's attitude in trying to help this subcommittee come up with those solutions.

I think the real question that we come down to, as I mentioned, is the question of how we can best obtain the standards. The issue with regard to the question of dual training and discovering abuses in dual training is exactly how high those standards can be.

Chairman Gramm mentioned the fact that she did not feel we could meet the standards that are expected in this legislation.

Do you have any suggestions or thoughts with regard to just what is likely to be a obtainable goal at some point in the future?

Mr. DAMGARD. I don't know that we are in the best position to assess the specifics, and I think I referred to the fact that 7,000 may not be just the absolute perfect number for determining whether or not it is a mature contract.

Perhaps such things as open interest and the types of contracts that are being traded—whether they are speculative or hedge positions—should have some bearing on that, as well. Indeed in 1974, you created the expert agency, the CFTC, to deal with these kinds of issues, and I don't know that they have ever had as strong a message from the subcommittee to give them some backbone as they have received today.

Our own feeling is that this carrot and stick approach the subcommittee is using is quite appropriate, and it is less important to us to determine just exactly what a specific test is in terms of an audit trail or when dual trading should be allowed and when it should not be allowed. What is important is to know that the subcommittee is going to continue to keep pressure on the CFTC and the exchanges, and in fact the entire industry, to make sure that the needs of the customer and the end user and indeed those that benefit from the market are paramount and that the exchanges are going to be required to consider what is in the best interests of the customer.

Mr. ENGLISH. Well, I think that is a good point. I think we would agree with you with the question of where that level should be.

I suppose it is like a drinking age, driver's licenses, taxes, or anything else. There is an arbitrary point in which a number is established. I might say for those who may not be familiar with it, the number 7,000 came primarily from the standpoint that some people we talked to within the industry, 5,000 seemed to be the number that most people agreed you reached the point that a contract was mature and liquid.

We simply went to nearly half again as much as a safety factor. Now, anyone who would like us to consider reducing that down to five and hit that number that everyone told us about, I suppose we could reconsider it.

But what we have tried to do instead is to build in safety factors, and in this case, nearly half again as much as a safety factor, we put the safety factor for transition to give the CFTC, so that we do not have a disruption on the contract.

We have included a provision that if it is an abberational increase, it goes over the 7,000, it should not be included. We have also included, of course, the fact that should the CFTC find in certain cases that even to include, I might say, otherwise threaten the public interest—which I mentioned this morning is pretty broad language—gives them a good deal of flexibility to make sure that we do not damage those contracts.

But there has to be a point to begin. That is the whole point. The bottom line is there has to be a starting point. I think that we have to underscore the fact that we still have a good deal of distance to do.

We have some people I think, unfortunately, that are willing to look back. They look and say, "Well, look how far we have come" instead of looking at how far do we have yet to go, and we are looking forward to working with FIA and trying to make sure that we establish goals that may just barely be on the outer reach of the industry, and we are going to prod and push, not only the industry, but if we have to, we are going to prod and push the CFTC if they require us to, to make sure that they help us reach that point.

Again, I just want to thank you for your testimony and I appreciate your suggestions.

Mr. DAMGARD. We are pleased to be here. We really support the thrust of the legislation. We believe the audit trail is more important than the dual trading provisions.

We think the key is really the Utopian perfect audit trail. Maybe that is unreachable, but I do not think we should stop trying to reach it and I think that the image of impropriety in our markets is probably as damaging as impropriety itself.

In the exchanges' defense, I believe that they are doing an infinitely better job than they have been doing in the past, and I think that computerized trade reconstruction in Chicago and the emphasis that the New York exchanges have put on audit trail in the last few years have made it less likely for people to be able to cheat and get away with it.

As a result, I think customers are getting a better deal than ever before, but it is never going to be good enough as long as there is a belief out there that there is something wrong.

I think I emphasized that volume is growing at a very, very fast rate in our markets. Somebody is doing something well and I think we ought to tell the exchanges that they are doing some things very well.

But that does not mean that we can let up, and do we have specific answers about whether or not dual trading should be allowed here or there, I think probably the exchanges should be heard on that subject louder than we do, but we think the carrot and stick approach that you are using is something that, in the long run, will be very, very good for the integrity of our markets.

Mr. ENGLISH. Thank you.

Mr. Coleman.

Mr. COLEMAN. Thank you, Mr. Chairman.

I too would like to commend you, John, and your association for the constructive comments that you have made on the record today. I, in looking through your testimony really do not see that you have any problems with the bill except for a couple of caveats that you have already mentioned.

Let me say that there has been some suggestion that what this bill represents is somehow going to move offshore much of the futures industry from this country. I would like to have you comment on that possibility, probability, and mention was made about other exchanges in the world and what rules they have, and so on, and so forth.

It seems to me that if we can restore the reputations that have been somewhat smudged here in the press and also to provide total confidence in the exchanges and the transactions being accurate, it seems to me people would want to flock to an institution that has these types of safeguards.

I would like to have you comment on this.

Mr. DAMGARD. Well, I think you are absolutely right. I mean I think the way to run the markets offshore, frankly, is to destroy their reputation for integrity.

I am not saying that they are in the least bit destroyed now, and I think we have to be very, very watchful of foreign competition. I think the offshore market's biggest opportunity would be if, in fact, our markets received a black eye and they would be able to prosper.

I also think that we are the established marketplace; the rest of the world comes to the U.S. futures markets to do their risk shifting. Our markets are the envy of the world. Not surprisingly, other countries have decided that if they are financial centers, they will have futures markets, as well.

We have seen a lot of activity in Japan and London in the last few years. These two centers are particularly interested in developing risk-shifting markets to complement their cash markets.

I think that it is probably reasonable to assume that as the Japanese markets mature and have liquidity, that the Japanese will use the Japanese futures markets to some degree, instead of the United States markets.

The Japanese Banking Federation has gotten together and formed a futures market in currencies, and that market will be operating during daylight hours in Japan. The Japanese exchange probably will have some effect on the business of the Chicago Mercantile IMM. I think it was in response to that, that the Chicago Mercantile Exchange, in conjunction with Reuters, came up with the GLOBEX idea, a 24-hour trading system.

Growth in absolute terms remains much greater in U.S. markets than it does in the international markets. However, as they come on-stream, I suspect these new international markets will be more attractive to people in their time zones.

Mr. COLEMAN. Thank you.

Mr. ENGLISH. Mr. Combest.

Mr. COMBEST. John, in your testimony where you mentioned about midway down on the second page, where you talk about the Chicago Mercantile Exchange special committee report and that they suggested dual trading be banned in mature, liquid markets.

Granted the fact that you do not know where the right level is, if it is 7,000, 5,000, or whatever the case may be, how do we determine what that right number is?

Mr. DAMGARD. I am proposing, Mr. Congressman, that maybe that is something that the CFTC on an ongoing basis, using more than just strictly a volume test, might be in a better position to judge.

I think what this committee has done today, and what it appears it will continue to do, is give the CFTC a lot more courage to act in these areas than it has ever had before.

I am not saying that there is anything wrong with the 7,000 figure. I am simply saying that I do not know. In the limited time I have had to discuss that figure with a cross-section of my board of directors, there was no unanimity—as there hardly ever is in a membership organization—that one figure is a magic figure.

So, for that reason, I am unable to sit here before you and tell you that I know precisely the right number. More importantly, we are endorsing the emphasis on the audit trail and the legislation in that area.

That is not to say that maybe 3 years from now, the people that have had to live by the 30-second requirement can not come back here and to the CFTC and make a strong case that the requirement is too rigid and should be amended.

But I do think that you are doing the right thing by holding the exchange's feet to the fire on audit trail and dual trading, because I think that is going to eliminate the customer abuses.

Mr. COMBEST. From the penalty standpoint, being in the business you are in and you are representing the industry, would you recommend that the penalty be a set penalty for a certain type of trading abuses, or do you believe that should be left up to the exchange that would be policing the trading?

Mr. DAMGARD. I think the penalty should be a strong deterrence.

Mr. COMBEST. I agree.

Mr. DAMGARD. With regard to specific levels, I frankly am not very knowledgeable about what those levels are right now. However, I think the penalties should be quite painful and I think sometimes those penalties should be banishment from the industry, and let the shoe fall wherever it may on that.

The last thing that this industry needs are the few people, the kind of cling to the periphery of the markets, that bring us this bad name.

The futures industry is an extremely important industry that touches every facet of economic life. Let these guys who are bringing us the bad reputation go back to selling aluminum siding.

Mr. COMBEST. I agree. I guess the question is, and I think, hopefully, the industry recognizes that it is to their best interest that a lot of the problems and perceptions, as you have indicated, the perception can be more significant than the truth, whatever the public perceives, but that the perceptions are bad and can have tremendously negative impacts.

I think we should make it very painful, too, literally, very painful for individuals to be involved in illegal trading. I guess the question I have—and when I ask this of the exchanges as we go through these hearings over the next several days—is: Should we legislate that penalty or should we leave that up to the CFTC, or should we leave it up to the exchange that basically regulates and determines the penalty?

But I think the more severe, the more harsh, the more of a deterrent there is in the penalty phase, the more the perception will be of confidence in the market. Off the top of my head, I would say that a good, strong message in the report language would alert the CFTC and the NFA and indeed the exchanges themselves that the committee expects to see these penalties be quite severe.

I think they should be fitting with the crime. I mean I don't think the penalties for the equivalent for a parking ticket should be as strong as the penalties for cheating a customer and abusing the system. Thank you, Mr. Chairman.

Mr. ENGLISH. Ms. Long.

Ms. LONG. No questions, Mr. Chairman.

Mr. ENGLISH. Mr. Gunderson.

Mr. GUNDERSON. Thank you, Mr. Chairman.

Two questions. First of all, as I reviewed your statement, I was struck by the fact that you seemed to support almost every recommendation.

Mr. DAMGARD. Except the telemarketing. We are not so keen about that.

Mr. GUNDERSON. Enforcement, that kind of thing, I am not critical of that. I guess I would ask more of a philosophical question from your perspective.

To what degree do you feel in-house exchange governance enforcement mechanisms working and what degree do we try to define that balance, CFTC regulation and exchange in-house governance? It seems to me that that is a philosophical question you have to face in light of inquiries.

Mr. DAMGARD. Well, the Futures Industry Association obviously represents a broad cross-section of all elements of the industry, but we have our roots in the brokerage community with the Shearsons, the Merrills, and the Dean Witters, and large Chicago houses that are not such household names like Refco, Stottler, and Gelderman. There have been concerns expressed from time to time that the governance of the exchange does not always take into consideration the views of those that feel that they are the links with the outside world.

In other words, we believe we are the link to the customer and we can best represent the public's interest in how these markets work. The exchanges are indeed owned by the seatholders, and the FCM community is far outnumbered by the local floor trader in terms of owning seats. From that standpoint, the FCM's voice is a minority, and while that has been frustrating in the past, I would not say we have not seen some progress.

I believe that that progress will continue and I believe with hearings like this, and with the interest of this subcommittee, it will probably continue at a little faster rate than it otherwise might have.

I would at this point not be so inclined as suggest that we legislate in this area, because I think that the CFTC, as the overseer, has a strong idea of the subcommittee's goals in this area.

Mr. GUNDERSON. One of the areas that I have been concerned with is developing policy area, the whole area of international futures, development of foreign futures as competition. How do we strike a balance in our regulations that do not drive people on to foreign exchanges, and yet at the same time, try to preserve integrity?

I am a little struck by Chairman Gramm's proposal that they want authority to investigate and regulate foreign. I do not know, it seems to be a bit of a unique proposal, but I see that you support the whole concept of cooperative enforcement efforts.

I would like you to elaborate a little as to what you see that we can rationally do in this area.

Mr. **Damgard**. Well, the theory of course is to make certain that customers outside the United States are not subject to the same standards as customers within the United States. We do not want to disadvantage U.S. customers on U.S. markets.

By the other hand, I do not think it is in the best interests of futures trading worldwide for pockets of liberian futures trading crop up and business flows to the marketplace that has the least regulation. Ultimately, that will cause the futures industry great embarrassment and a black eye.

Futures trading has led the way in terms of being a 24-hour global business perhaps because products like crude oil and gold have worldwide appeal, whereas, 100 shares of a specific stock like PEPCO may have limited appeal.

I think that foreign markets are bound to grow and we ought not to worry about that growth. We ought to spend more time worrying about our own markets and encourage regulators to come up with some sort of worldwide regulatory parity.

To that end, I think that the CFTC engages in twice a year meetings with their fellow regulators worldwide.

Mr. **Gunderson**. Thank you.

Thank you, Mr. Chairman.

Mr. **English**. Thank you very much, Mr. Gunderson.

John, we appreciate your testimony. Thank you very much. We are looking forward to working with you.

Mr. **Damgard**. Thank you very much, Mr. Chairman.

Mr. **English**. Our next witness is Mr. Frank Beurskens who is with the National Grain and Feed Association here in Washington.

Mr. Beurskens, we want to welcome you here to the subcommittee today.

STATEMENT OF FRANK BEURSKENS ON BEHALF OF THE NATIONAL GRAIN AND FEED ASSOCIATION

Mr. **Beurskens**. Thank you, Mr. Chairman.

Mr. Chairman and members of the subcommittee, my name is Frank Beurskens, and I am president of Advance Trading, Inc., in Bloomington, Illinois.

My company works with both cooperative and private country grain elevators and directly with farmers, as well as numerous small commercial hedgers in the marketplace.

I am presenting this statement today on behalf of the National Grain and Feed Association. The membership of the National Grain and Feed Association encompasses more than 1,300 companies representing some 5,000 facilities that handle and merchandise about two-thirds of all U.S. grain and oilseeds.

Members of the National Grain and Feed Association rely heavily upon the futures markets to hedge purchases and sales of grain and/or grain products. Continuation of a viable futures market is critical to a competitive and efficient marketplace for agriculture.

Futures markets provide efficiency and risk transferral mechanisms necessary to offer marketing services at the lowest possible cost, which benefits both the producer and the ultimate consumer of agricultural commodities. Futures markets are truly the cornerstone of an efficient marketplace.

This year, 1989, marks the 15th anniversary of the Commodity Futures Trading Commission as an independent body regulating futures trading. We continue to believe that all futures markets should be regulated by an independent regulatory body.

We support an open-ended reauthorization, with no specific sunsetting of the CFTC. CFTC, in our view, has earned the right to become a permanent Federal agency, and absent the need to embark on the reauthorization process every 3 or 4 years, should be able to devote more of its resources to actual market surveillance and enforcement activities for which it was intended.

While not under active consideration, the issue of margin setting authority being vested in one or more Government agencies remains a primary concern for our industry. There seems to be continuing confusion about futures market margins that cause some to believe that there is a similarity between margins on securities and margins on futures.

The function of the futures market is not to transfer title, but rather to transfer price risk. Futures margins act much as a performance bond, and depending upon price volatility and risk in any given market, is subject to change, and in our judgment, only the individual exchanges have the capability to deal with the logistical realities of margin setting-responsibility.

Notwithstanding the current investigations of some exchange activity, from our perspective as commercial hedgers in the marketplace, we believe that the commodity markets are generally functioning very efficiently under the current regulatory structure.

We believe that an overreaction in the name of regulation could well do considerable damage to efficiently running markets. At the same time adequate self-regulation by exchanges, self-regulatory organizations and the CFTC must be taken very seriously if the self-regulatory structure is to be maintained with confidence.

A principal issue of these hearings and of H.R. 2869 is how best to regulate the markets to minimize potential abuse of dual trading practices. First, it is vital that Congress understand that the practice of dual trading is very necessary in many markets to maintain market liquidity.

Adequate liquidity is important to all hedgers as the cost of placing hedges in the market can go up tremendously in a thin, lightly traded market. Clearly, however, the use of dual trading can be abused, and close surveillance by the CFTC and exchanges is necessary.

H.R. 2869 would ban dual trading in markets whose daily volume exceeds 7,000 contracts. However, as we understand, there would be a number of exceptions to this rule.

While this section of the bill is well-intentioned, and correctly links the potential for dual trading abuse with the need for improved audit trails, we believe the provision would create a number of problems.

First, it is very difficult to determine a single volume, whether that is 7,000 contracts traded daily, or some other figure that defines a liquid market, that does not need the flexibility of dual trading to encourage volume.

Second, allowing customers to give written authorization to brokers to override the dual trading ban would lead to the question of just who is the customer. Is the customer, for instance, the futures commissioner merchant sending order to a broker on behalf of a client, or the introducing broker sending order to a futures clearing merchant, or would every public customer have to authorize a particular floor broker to be able to dual trade?

Third, but most importantly, the accuracy of the audit trail is paramount to improving exchange surveillance and should be pursued vigorously, but technological feasibility and the cost of 100 percent accuracy have to be reviewed.

We believe that dual trading is an important part of marketplace efficiency and Congress should endeavor to avoid an outright ban of dual trading in any futures market, if at all possible.

While we agree with the intentions of Congress to guard against abuse of dual trading, we believe it is very difficult to set such specific guidelines applicable to all markets, without creating some substantial adjustment difficulties in certain markets.

We would support an approach giving CFTC specific legislative objectives and authorizing CFTC to write specific rules with stringent penalties for noncompliance. We believe this approach would provide adequate public protection and preserve the market liquidity necessary for market efficiency and viability.

Other items addressed by H.R. 2869 include a specific restriction on trading between members of broker associations. Artificial restrictions on trading volumes place an additional constraint on efficient marketplace performance. Thus, if there is a means of equivalent protection through better audit trails or some other mechanism that does not add another market restriction, it would be deemed as more desirable.

We support the provisions in H.R. 2869 that would prohibit the participation on governing boards and disciplinary panels by those members found guilty of major rule infractions.

Our association also welcomes the expansion of representation of nonfloor membership on governing boards of exchanges.

Mr. Chairman, we fully support other provisions of H.R. 2869 intended to encourage a high level of ethics and integrity in the function of the futures market.

We have appreciated this opportunity to present our views on CFTC reauthorization, and I would be happy to respond to any questions the subcommittee may have.

[The prepared statement of Mr. Beurskens appears at the conclusion of the hearing.]

Mr. ENGLISH. Mr. Beurskens, I appreciate it very much. The question was asked earlier—I thought Mr. Nagle might be here because this is the question he raised, and I want to raise it with you—as a result of the actions taken last week on the Board of Trade, do you have any idea of what the real effect on cash prices was to farmers, what kind of a loss farmers may have suffered?

Mr. BEURSKENS. It is difficult to separate the impact of weather on price. That has been a very volatile factor reflected in yesterday's market of being limit down.

But if we look at several different markets from the period of last Tuesday, the day before the announcement by the Board of

Trade, and compare those to the closing prices Friday, it should give us an indication as to what the final impact would have been to a producer.

If we look at the export market, which is as many articles have mentioned, a major factor that was involved in this debate, the value of soybeans delivered to the Gulf on Tuesday, July 11, was $7.24½ cents a bushel. That was the day before the announcement.

On Friday, at the close, July 14, the price of soybeans delivered to the Gulf was $7.24¼ cents, one-quarter of the penny a bushel less Friday than the day before the announcement was made.

If we look at Peoria, Illinois, the price for beans delivered to a terminal, to a riverhouse in Peoria, on the Tuesday before the announcement was $7.03 a bushel, and the price of beans Friday was $7.02¼, three-quarters of 1 cent less.

If we look at Decatur, Illinois, which is a primary processor market, the bid to a farmer on Tuesday before the announcement was $7.23 a bushel. On Friday, at the close, that price was $7.06½ cents a bushel, 17 cents less.

If we were looking at the new crop prices during this same period, the new crop price for soybeans on Friday was actually 7½ cents a bushel higher than it was the day before the Board of Trade made that decision.

The realities are in the pricing, No. 1, the trade has known, as was mentioned earlier, not just since last May, but this situation has existed in the soybean market for over 1 year, and all of the professionals in the market—and one would have to be pretty absent of news not to realize that there were fewer deliverable stocks than there were positions, open interest in the marketplace—to understand that there really was not business for anybody particularly a farmer to have any futures position in a July contract.

Our firm, representing country elevators and producers, had one, 5,000-bushel contract long in the July contract Wednesday morning, and I think that was indicative of any professional that has been in the marketplace. There was no reason to be in the July futures contract for a novice particularly.

So, from a cash bid standpoint, one would really have to question the articles that have been in the Post and the Journal as to just where did these massive price losses occur. I do not see them in the bids that are reflected from what I have just quoted you.

Mr. ENGLISH. Mr. Coleman over here was just reading in the newspaper there is a 26-cent difference.

Mr. BEURSKENS. What market, what location?

Mr. ENGLISH. This was on the Board of Trade.

Mr. BEURSKENS. What day?

Mr. ENGLISH. Today's paper is what he has.

Mr. BEURSKENS. There was a weather forecast Friday that had a three-quarters to 1½-inch of rain in the entire grain belt.

Mr. ENGLISH. How many cents does that add or take away?

Mr. BEURSKENS. From what I gathered yesterday, the market was down 30 cents in beans and 10 cents on corn, the maximum permissible amount.

Mr. ENGLISH. So, are you telling us that basically you cannot say how much farmers lost or what kind of this impact that this had on us, is that basically what you are telling me?

Mr. BEURSKENS. Yes.

Mr. ENGLISH. So, nobody can tell, you do not know whether it is weather, you do not know whether it is this action?

Mr. BEURSKENS. The only way an individual could make a statement that a producer lost money is if he sold beans Wednesday after the announcement and liquidated everything he owned, then he honestly could say that he lost money.

If he still owns the beans that he owned last Tuesday, he may have lost money, but it has been a result of the weather, not as a result of any move by the Chicago Board of Trade.

Mr. ENGLISH. So, you are telling me that in effect, when the price falls as a result of action, that it has no impact on farmers?

Mr. BEURSKENS. No more impact than we have had ever since the 100 years the Board of Trade has been in existence.

Mr. ENGLISH. I guess that is where a lot of farmers would say it has had one heck of a lot of impact. I have had a lot of my farmers tell me that.

It is a price-setting mechanism, is it not?

Mr. BEURSKENS. Yes, it is.

Mr. ENGLISH. So, if it is setting the price, and something has an impact on it, how does that not have an impact on farmers?

Mr. BEURSKENS. The final decisionmaking still lies in the farmers' hands. The price of soybeans at fall was $9 a bushel in the Midwest, yet the majority of all producers in the United States felt that that was not an adequate price and consequently held on to their soybeans.

It is a function of the market to determine what that price should be, and it appears as if it has done a very accurate job.

Mr. ENGLISH. That is true up to a point. If, in fact, the price of my product was higher 1 week ago than it is today, and someone artificially took an action that drove that price down, an action which I was not a part of and not a participant in, I have lost, did I not?

I mean there is no way that I can get away from the fact that someone, through an arbitrary decision, cost me money.

Mr. BEURSKENS. If the farmer was located anywhere tributary to the inland waterway system, his bid was exactly the same Friday afternoon as it was Tuesday.

Mr. ENGLISH. Well, I am sure a lot of farmers are going to take comfort in that out there, that they did not lose anything. I think they are going to strongly disagree with you.

I imagine you will probably get a little mail on that if the press report says that you take that position, because I think that anytime that the market price goes down, they figure that they lose money, and it is hard for me, quite frankly, not to agree with them. I think they do, too.

Mr. BEURSKENS. My point for bringing up the price changes or lack thereof is to emphasize the fact that the information that has been in the newspapers concerning the activity of last week is by no means enough information for any of us to formulate an opinion one way or the other until we see the expiration of the July contract this Thursday and until the CFTC and the Chicago Board of Trade can make public exactly what did happen last week.

I think until we see that information, the information in newspapers really should not be looked at as an accurate source of information.

Mr. ENGLISH. Mr. Coleman.

Mr. COLEMAN. I am a little bit surprised that the chief users of the exchanges would not want to see a comprehensive audit trail established as soon as possible to assure the accuracy of your trades being transacted in an atmosphere——

Mr. BEURSKENS. We would like to see the audit trail as soon as possible.

Mr. COLEMAN. But I gather from your testimony you kind of waffle a little bit on that as we go through here. I guess it is just time, I think Glenn mentioned it earlier, 15 years we have looked at this issue, and pursued it, and we are trying to get it established at a higher percentile and a faster pace I think it would help everybody.

Let me just say, in your question about authorizing brokers to go ahead and dual trade, that it is our intent, at least the chairman and my own, is that we would have every public customer authorize a broker in order to dual trade.

You raise that as a question, and I would want the record to show that is our intent. That may or may not, in your mind, be the correct response, but that is our intent for the record.

I thank you for your testimony.

Mr. ENGLISH. Mr. Combest.

Mr. COMBEST. I have no questions.

Mr. ENGLISH. Ms. Long.

Ms. LONG. Yes, Mr. Chairman.

I would like you to provide some kind of estimate of the amount of liquidity that is provided by dual trading, how much you believe it enhances the markets.

Mr. BEURSKENS. All I could respond is as a participant in the market what I sense, because I do not have the numbers to support what I sense.

One of the most common transactions that a country elevator would enter into in the marketplace is the concept known as spreading, where we will buy one month and sell another month at the same instant.

Oftentimes, particularly with the advent of the elimination of Government storage programs, Commodity Credit programs, storing grain, the function of the marketplace now is to pay merchants to store grain and keep it off the market from fall and reward you by paying a premium for grain delivered in the future versus the nearby.

It is a very normal transaction for a country elevator to be, for instance, buying December corn and selling May corn at a specific spread difference. That transaction is typically handled by a spread broker in the pit, and there are many instances where the best spread brokers in the pit have at times had to take a position, one of the sides of that transaction, into their own account in order to get that spread traded at what they felt was the market.

If we eliminate dual trading, we could impair the ability for spreads to be traded in the marketplace which would directly impact the ability of a country elevator to be able to profitably operate his facility.

Ms. LONG. I would like to see some hard data on that because it seems that whenever we ask a question, for example, how much was the price affected, you say you cannot give us some kind of estimate, that you do not believe that it was really affected.

Yet, you make a statement as part of your testimony that dual trading provides liquidity that is needed in the markets. I would like to see some numbers to support that particular statement.

Mr. BEURSKENS. From our perspective, in terms of quantitative information to support that statement, it does not exist because we do not have anything to compare it against. That is, there are no markets that have not allowed dual trading to compare the liquidity, and it would be very difficult to support that.

One can only go off of experiences in terms of trading in the marketplace which may or may not be adequate for what you are asking.

Ms. LONG. But in the interests of consistency, when you want to make a point in your favor, or in favor of your particular position, you seem to hedge, to use a term. I think that if you are going to be consistent, and if you are going to be convincing, at least to me, and I would hope to my colleagues, you are going to have to provide some hard data to convince us of the importance of dual trading for liquidity.

Mr. BEURSKENS. I appreciate that.

Mr. ENGLISH. Mr. Gunderson.

Mr. GUNDERSON. No questions.

Mr. ENGLISH. Mr. Tallon.

Mr. TALLON. Mr. Chairman, thank you.

You mentioned and I cannot find it in your testimony—is it all right if I call you Frank?

Mr. BEURSKENS. That is fine.

Mr. TALLON. Thank you—a futures clearing merchant. Was that a term you used in your testimony?

Mr. BEURSKENS. Yes.

Mr. TALLON. A real concern, of course, is front-running or trading ahead of a customer. By any kind of ban on dual trading on a trading floor, we are in no way addressing any kind of front-running or trading ahead of a customer that could possibly occur with a futures clearing merchant, is that correct?

Mr. BEURSKENS. It is our desire, as I believe was mentioned in the testimony, that we are strongly in favor of maintaining a highly accurate audit trail, and with the availability of that audit trail, fronts trading should be caught and penalized severely.

We do not like the concept of banning dual trading entirely solely as a method to try to catch that portion of that volume that potentially could be front-running activity.

Mr. TALLON. But what I am trying to determine is there could be—there could be, if we are looking at the abuse which is front-running or trading ahead of a customer, off the floor, and if we wanted to really look at improving the audit trail, perhaps we might even need to look at the—again using your term the futures clearing merchant—and how orders were being handled when they received them.

Mr. Beurskens. You are right.

Mr. Tallon. Thank you.

Mr. English. Thank you, Mr. Tallon.

Mr. Beurskens, we appreciate your testimony. Thank you very much.

Mr. Beurskens. Thank you.

Mr. English. I am going to recognize Mr. Coleman to introduce our next panel of witnesses.

Mr. Coleman. Mr. Chairman, our next panel consists of two individuals, the chairman of the board and the president of the Kansas City Board of Trade.

I am happy to welcome to our hearing and to our subcommittee, Michael Braude, who is the president, and Roger Stover, who is the chairman this year.

I have had an opportunity, of course, to visit with these folks from time to time as a local Congressman and also to thank them for providing us information and insight into the industry from time to time. I look forward to their testimony.

STATEMENT OF MICHAEL BRAUDE, PRESIDENT AND CHIEF EXECUTIVE OFFICER, KANSAS CITY BOARD OF TRADE, ACCOMPANIED BY ROGER STOVER, CHAIRMAN

Mr. Braude. Congressman English, Congressman Coleman, and distinguished members of the committee, Roger Stover, the elected chairman of our exchange, and I very much appreciate the invitation to appear here today to discuss the Kansas City Board of Trade's views on your proposal to reauthorize the CFTC.

I am Michael Braude. I am president and chief executive officer of our exchange.

Mr. Chairman, a member of your subcommittee staff visited the Kansas City Board of Trade on two occasions during the course of your subcommittee's work and we want you to know that we appreciate the spirit of cooperation that characterized those visits.

We felt that the intent of both of his visits was to learn as much as possible about the operations of the Kansas City Board of Trade and in particular about our audit trail.

Let me preface my remarks with the statement that since I joined the exchange 5½ years ago, my experience has been that the CFTC has done an exemplary job at governing our industry through a very challenging period of time, a time of phenomenal growth in trading volume, in numbers of products traded, and in the diversity of instruments available for trading.

I would like to move now to the specific provisions of your bill.

First of all, permanent reauthorization. Our exchange unequivocally supports the proposal to make the CFTC a permanent government agency. Our industry has matured over the past 10 years into a key factor in international risk management, and the CFTC has proven itself as a capable regulator during that period.

We feel that the process of continual reauthorization causes an unreasonable drain on the agency, the industry, and in fact on congressional resources. The current structure hinders the effectiveness of the Commission by making it a political pawn precisely at those crisis moments when full Commission resources are needed to deal with the situation at hand.

Moving now to dual trading. Since the news broke earlier this year of the investigations into the Chicago commodity markets, we feel that dual trading has become the battering ram of those who would like to see the industry constricted.

Our exchange would like to use this opportunity to put forth that dual trading, in and of itself, is not the problem; dual trading is an accepted, legitimate and necessary component to futures trading, particularly at smaller exchanges like ours.

The key to dual trading lies in whether the exchange in question has the appropriate systems in place to detect dual trading abuses. I think we have heard that over and over again today.

These procedures may vary by exchange, depending on such variables as the number of traders in a particular pit, trading volume, and the sophistication of the exchange's computerized surveillance system.

We at the Kansas City Board of Trade are continually upgrading the effectiveness of our audit trail surveillance system, as are most other exchanges, because we have long recognized the need to innovate to keep up with the ever-changing markets.

Dual trading has been allowed these many years in the trading pits because it yields a significant economic advantage. By improving the liquidity of the pit, dual trading helps to assure as narrow a bid-ask spread as possible, with benefits accruing to all participants in that market.

A natural consequence of restricting dual trading is to reduce the efficiency of the pit by constricting the population of brokers available to fill orders. This reduces pricing, as well as execution and efficiency. If not handled with care, restrictions on dual trading can intensify the very problems this subcommittee is trying to solve and perhaps cause a few more.

Current CFTC regulations clearly detail the responsibility of exchanges to survey, examine, and investigate their markets to protect against trading abuses, including those that result from dual trading.

It is our opinion that any exchange that can demonstrate itself capable of fulfilling that duty should be allowed to continue to dual trade. Conversely, any exchange that cannot prove itself capable should not be allowed to dual trade.

Your committee recognizes that a key to effective monitoring of trading activity, including dual trading, is through an effective audit trail. We completely agree with you. Our exchange, the Kansas City Board of Trade, was the first exchange to require what we call "timing to the minute." Let me be clear that means manual timing to the minute.

We practiced manual timing to the minute in our pits long before we were required to do so by the CFTC. Our system has been recognized for its effectiveness since its implementation.

Nonetheless, people who have not been directly involved in the development of such timing systems should be fully aware of the difficult nature of the work involved.

While the Kansas City Board of Trade is more than willing to work toward the committee's proposed 1-year requirement of a stricter 1-minute standard and the 3-year requirement of a 30-second rule, we urge the committee to allow the CFTC reasonable flexibility in determining how and when the standards have been met.

The challenge of the task will not be clear until the work has begun.

On broker associations, our opinion on broker associations is similar to our opinion on dual trading. Broker associations in and of themselves are not the problem if an exchange has a mechanism in place to detect violations of trading rules. In fact, formal and informal broker associations may help the markets by improving trading accuracy and efficiency.

Restricting the type and degree of trading between members of a broker association is second best to again having the procedures in place to detect any abuses as they occur.

The placement of restrictions also assumes that broker associations are a formal business entity, when in fact the majority of such associations are quite informal and can very easily be camouflaged or disbanded to circumvent restrictive rules.

To be effective, any proposal that deals with broker associations should, at a minimum, define what a broker association is and require that groups meeting that description be recognized as such with the appropriate exchange.

On governing boards, our exchange has no problem with your proposals to make members found guilty of certain exchange violations ineligible to serve on governing boards and certain exchange committees or disciplinary panels for a set period of time.

Likewise, our exchange has no problem with having 20 percent of its board members from outside the exchange. Parenthetically, we practically do that right now.

On other issues, our exchange can also accept the provisions as put forth in the proposal to require the establishment of disciplinary committees at each exchange that are large enough to include a majority in a category other than that of a person being tried.

We can accept requiring the CFTC to place stricter procedures to regulate telephone solicitation of commodity accounts.

We can accept requiring the CFTC to establish standards to register floor traders, and finally, to require new registrants to attend ethics training.

In summary, the Kansas City Board of Trade applauds the subcommittee's recommendation to make the CFTC a permanent agency. The exchange also respects the committee's attempt to protect the public good by trying to legislate against potential trading abuses, specifically from dual trading and broker associations.

However, we feel that those issues, as well as the general good of the investing public, can best be served by focusing each exchange's efforts on developing a comprehensive audit mechanism to seek out rule violators.

Those exchanges not able to meet a reasonable standard should be made to confront the consequences.

The U.S. commodity industry has established itself successfully in the international financial marketplace. As in any growth industry, however, continuing success will depend on how we meet the challenges that lie ahead.

The committee's proposal, if modified to include some of our suggestions, we think provides a very acceptable framework on which to base these efforts.

We commend you for your work in drafting this legislation. We thank you for the opportunity of appearing here today, and Roger Stover and/or I would be happy to answer any questions you have, Mr. Chairman.

[The prepared statement of Mr. Braude appears at the conclusion of the hearing.]

Mr. ENGLISH. Mr. Braude, I guess the question comes down to the fact that you all have a very high percentage of competence or accuracy in your audit trail.

Mr. BRAUDE. Yes, we do, Mr. Chairman. I believe that had the representative of the Commission answered specifically your question today, we would have been one of the exchanges cited.

Mr. ENGLISH. Well, we have the numbers on it here, and in looking at this, as I understand it, your overall accuracy rate is 96.8 percent and it ranges all the way from 96.5 for some transactions up to—at least it is my understanding on wheat option—up to 99.14.

Mr. BRAUDE. That is correct. We take pride in that.

Mr. ENGLISH. Some people would say, in fact I have heard it said, well, the small exchanges can do that, but the big exchanges cannot.

Is that in fact true, are the techniques that you all are employing that much different from the other exchanges that allows you to reach that, or is it simply because the volume that you trade in on a number of these different contracts is smaller and therefore allows you to reach that accuracy?

Mr. BRAUDE. Mr. Chairman, I think that is a factor, but respectfully, I cannot comment on what the other exchanges can do. We have kind of a full-time job doing what we think we have to do.

Now, I think size is certainly a factor, but I really think that is a question that the other exchanges would have to answer.

Mr. ENGLISH. Well, they are going to say they are not that familiar with what you are doing.

Mr. BRAUDE. Just as we invited your subcommittee staff down, we would be happy to have any exchange come in and study our audit trail procedure anytime they want.

Mr. ENGLISH. So it is going to be up to our staff to tell us what the differences are between each of the exchanges and whether or not they can meet these goals?

Mr. BRAUDE. Well, quite frankly, one of the things that we tried to do when your staff was out in Kansas City was to demonstrate to them that there are unique qualities to an exchange, and obviously our goal was simply to show them what we do, how we do it, and the effort that we have made to achieve as close to that 100 percent as we can, and frankly we are very proud of what we have achieved.

Mr. ENGLISH. And you are not familiar, then, with the differences between how you conduct your audit trail as opposed to how one of the other exchanges conducts theirs?

Mr. **Braude**. Well, I am somewhat familiar, but again, I am not familiar enough to describe it in detail. I think every other exchange is going to appear here.

Mr. **English**. Mr. Stover, are you familiar with that?

Mr. **Stover**. No. I mean I have only traded in Kansas City and visited the Chicago Exchange, I believe.

Mr. **English**. Well, you are aware of the fact that your audit trail is different from other audit trails?

Mr. **Braude**. Absolutely, and so is our timing mechanism.

Mr. **Stover**. Timing mechanism, I suppose.

Mr. **English**. So, your approach is different?

Mr. **Braude**. Yes, sir.

Mr. **English**. The elements that are contained in that are different?

Mr. **Braude**. Yes, sir.

Mr. **English**. And it would appear that some are working better than others.

Mr. **Braude**. Yes, sir.

Mr. **English**. And we have got some exchanges that seem to be having a great deal more success than others in reaching these goals.

Mr. **Braude**. Yes, sir.

Mr. **English**. Do you feel you are at the point that you have achieved perfection?

Mr. **Braude**. No, sir. We think, as I mentioned in our testimony, we are continually refining. In fact, I think in the period since the representative of your subcommittee was in Kansas City, we have made a couple of automated changes that hopefully will get those percentage figures higher than what you just cited.

Mr. **English**. I also note, the point that I made, it appears on some contracts you have a higher percentage of accuracy than you do on other contracts.

Does it vary from contract to contract as far as the accuracy is concerned?

Mr. **Braude**. Yes, sir. Again, the lower volume contracts have the higher percentage of accuracy, and what we are working on now is to get it up on the higher volume ones.

Mr. **English**. Does the fact that certain times of the day, when they are involved, you have fast trading with regard to some of your contracts, you have that kind of volumes or not?

Mr. **Braude**. I think we have worked pretty hard on eliminating those differences, and I do not believe you would find that the case right now.

Mr. **English**. So you do not have so-called fast trading?

Mr. **Braude**. We do have fast markets, yes, sir.

Mr. **English**. During that particular period, is it harder to obtain this degree of accuracy than it is at others?

Mr. **Braude**. Yes, it is, but we do increase our surveillance, particularly our visual surveillance at those periods of time.

Mr. **English**. So, basically, we are talking about the greater the volume, the greater the amount of activity at a certain time, the more difficult it is to maintain the accuracy of the audit trail?

Mr. **Braude**. I think that would be an accurate statement.

Mr. **English**. Thank you very much.

Mr. Coleman.

Mr. COLEMAN. Michael, I will not ask you to comment on other people's audit trails, but let me put you in somebody else's shoes. Maybe you would be more familiar with this.

Let's assume that you had control over the CFTC and that you were trying to get some of your sister exchanges that had a larger volume, let's say, in Chicago and New York, come up with an audit trail which is more precise than what they currently have.

How would you do that?

Mr. BRAUDE. Well, Congressman Coleman, very frankly, I do believe—and I was not trying to be facetious in answer to the chairman's question—I think they do have a different set of problems and I really would not be so presumptuous as to try to address those.

We tried to make the point when your staff was out, and I have tried to make it here today, that each exchange is unique and we have got a pretty full platter trying to meet the needs of our own exchange.

I would tell you again that any exchange is welcome at any time to come out and we would——

Mr. COLEMAN. I am not trying to ask you to cast aspersions on somebody else's administration of their exchange, but you were here this morning, you heard me ask Wendy Gramm, and you heard her testimony. Somehow I guess the desire is to keep muddling through like we have been with some sort of amorphous vision of what an accuracy percentage ought to be. We know the exchanges are trying to come up with some package to get it up to 90 percent, and somehow that is going to be the goal. Basically, other than cutting off new contracts and a few hassling maneuvers that the Commission can do, I guess they are just holding out hope that the exchanges are going to do this on their own.

I guess what we are saying is that it is going to have to be more than just hope, and if you were not doing a good job in Kansas City, we would ask you to do better, and we would not just hope that you would do better.

Mr. BRAUDE. Well, Congressman Coleman, I would say that philosophically, I would not have any problem with setting a rather high percentage and mandating that that percentage be met. I mean I do not think that that is an unreasonable request.

Mr. COLEMAN. We have not even gone that far.

Mr. BRAUDE. I understand that.

Mr. COLEMAN. We have only said to them to come up with some sort of device which is verifiable to reconstruct the accuracy as determined necessary by the Commission, so they can enforce provisions of the act. So, it would not have to be 95, 96. It could be 91, I do not know.

Mr. BRAUDE. We find nothing unreasonable about that.

Mr. COLEMAN. You should not have any problems with that.

Mr. BRAUDE. Absolutely not.

Mr. COLEMAN. I know you are stating this for the record. It absolutely does not impact your operation at all now, and you are under 7,000 contracts. So what you are saying here today is not self-serving.

Mr. BRAUDE. That is correct.

Mr. **Coleman**. It is more of what you really believe in a philosophical manner.

Mr. **Braude**. That is exactly right.

Mr. **Coleman**. Let me ask you this question, though, that was asked of Dr. Gramm. You have read the bill here, and we give them all sorts of exemptions or ways to opt out of this ban on dual trading even if it "threatens the public interest" whatever that is.

Would you not say the Commission would have plenty of opportunities to exempt people from this prohibition?

Mr. **Braude**. I would believe that is correct, yes.

Mr. **Coleman**. I mean they could increase, if nothing else, the 7,000 contracts to 300,000 contracts, and everybody would be exempt.

Mr. **Braude**. I agree with that. Congressman Coleman, you hit a point that I think deserves some emphasis, and that is that last year in our wheat pit, which is our major pit, our average volume of trading as defined by this bill was about 5,300 contracts a day, so, yes, we would be exempt.

You are also 100 percent correct that philosophically—and I think that is the spirit of your bill—we believe that dual trading should be permitted in any pit that has a satisfactory audit trail.

I think essentially—you and I visited about this personally many times—we are saying essentially the same thing.

Mr. **Coleman**. Yes. We heard testimony today. We have a study going on about dual trading and its impact, and yet we are not sure, and nobody seems to know for sure in the industry, what impact this will have on liquidity, even when you have 100,000 contracts.

Mr. **Braude**. I can tell you, and I think this addresses a little bit Congresswoman Long's question, we have done a pretty extensive study to see what percentage of the volume of our wheat pit trading is done by dual traders, and it runs somewhere between 25 and 30 percent.

Mr. **Coleman**. And that is a small volume.

Mr. **Braude**. Yes, compared with an average daily volume of about 5,300 contracts.

Mr. **Coleman**. Could I ask one question of Mr. Stover.

We have heard some testimony that if we prohibit dual trading, that the people who would be doing trading on the floors would be more inefficient, less experienced, they would not be handling it right, you know these arguments, you have heard these arguments.

Could you comment on that, again not for your exchange, but for others.

Mr. **Stover**. It has not been many years ago, maybe 3 or 4 years ago, that there was very little activity in the grain markets and in our futures pits specifically. I think it has been that way since I have been in the business. Since 1971, we have had up cycles, storage years, trading years, and it is difficult to maintain qualified personnel from slow times to good times.

I think that when markets are very, very slow, a person is not going to have enough brokerage to make a living on. This goes sometimes month to month or we will have flurries in the summer and then it will slow down to very small volumes.

You have a period of time where you need brokers to get their feet on the ground and to establish themselves before they get substantial decks of orders, and for them to survive and pay the bills, they are going to have to do some trading, as well as try to pick up the scrap decks.

When you come down to an exchange, you do not walk in there without a lot of competition. So, it is a matter of trying to hang on until you get any business established, and it is tough sometimes.

I guess what I feel is that in many instances, with the elimination of dual trading, the current brokers would be more monopolistic, less competition.

Mr. English. Ms. Long.

Ms. Long. The Chicago Board of Trade last week called an emergency order and required liquidation of soybeans above a certain level. In earlier testimony today, when we were talking with Dr. Gramm, we talked about the role of the CFTC, and it seems to me that it might make more sense or might be more effective of the CFTC were notified before that kind of order were made, and if the order were, in fact, made by the CFTC given that the CFTC should be the most objective body to make such a determination regarding the specifics of the order and when the order is made, and so forth.

Do you see any problems with requiring an exchange to, first of all, notify the CFTC before making such an order? The second part of my question is: What kind of problems or are there any problems with requiring that the order come from the CFTC rather than from one of the exchanges?

Mr. Braude. I might mention in the 5½ years that I have been at our exchange, the only emergency actions we have taken were during the week of October 19, 1987, when a couple of times we suspended trading, not in our wheat pit, but in our value line pit because there was so much trading with the S and P.

On those occasions, Congresswoman Long, we did notify the CFTC prior to taking that action. So, I think that in answer to the first part of your question, I think no, there would be no problem in notifying them before the action.

Now, whether or not the action should be—again, as I think was testified to this morning by Chairman Gramm, the CFTC still has the power to order emergency action, so that it kind of seems to me that if, one, we notify them in advance, and two, they still have that power, you have about accomplished what you are saying.

I guess under their emergency power, we notify them in advance, if they do not want it, they can just institute some other emergency action, so I think you could accomplish it.

But do I see any problem with notifying them in advance, the answer is no.

Ms. Long. Thank you.

Thank you, Mr. Chairman.

Mr. English. Mr. Gunderson.

Mr. Gunderson. No questions.

Mr. English. Mr. Tallon.

Mr. Tallon. Mr. Braude, I think you mentioned in maybe a question Mr. English or Mr. Coleman asked you, that there are inherent differences in exchanges, whether it is a livestock contract or a sugar contract, the trading volume is different. You do not know what kind of technology and what kind of software exactly another exchange is using.

I just simply say that we might be aware when we start mandating time stamps and one thing and another, that we understand that we are dealing with different entities.

Would you care to comment any further on that?

Mr. BRAUDE. Yes. You look at a typical day, Congressman, in our wheat pit there is probably 45 to 50 traders on a good day. If you look at some of the pits in Chicago, there is 700 to 800 people in the S and P pit, or the Treasury bond pit at the Merc.

Obviously, the technology involved in floor reporting or any other factor is different, so, yes, I would certainly concur with that.

Mr. TALLON. Thank you very much. I yield back the balance of my time, Mr. Chairman.

Mr. ENGLISH. I want to thank you both for your testimony. It has been extremely helpful to us. I also want to tell you how much I appreciate the cooperation that you gave to our staff over the past few months and the hospitality that you have shown the subcommittee.

Mr. BRAUDE. Thank you. The welcome continues.

Mr. STOVER. Thank you.

Mr. ENGLISH. Thank you very much.

Our next panel is Mr. Bennett J. Corn, who is president of the Coffee, Sugar, and Cocoa Exchange in New York; Mr. Lou Guttman, who is with New York Mercantile Exchange in New York City; and Mr. Robert E. Fink, who is chairman of the Commodity Exchange, Inc., in New York.

As I understand it, Mr. Guttman, you will testify first, is that correct?

Mr. GUTTMAN. Yes, Mr. Chairman.

Mr. ENGLISH. Let me also say that after reviewing your written testimony, we want to encourage you to summarize that testimony and we appreciate it very much.

STATEMENT OF Z. LOU GUTTMAN, CHAIRMAN OF THE BOARD OF DIRECTORS, NEW YORK MERCANTILE EXCHANGE

Mr. GUTTMAN. I will endeavor to go through this as quickly as I can, Mr. Chairman. I do want to emphasize the last few pages of our testimony because I think it is quite important to us in New York, and it might help us through these next few weeks, possibly months.

Mr. Chairman, members of the committee, my name is Lou Guttman. I am the chairman of the board of directors of the New York Mercantile Exchange. On behalf of the exchange, I wish to thank you for the opportunity to appear before this committee to present our views concerning H.R. 2869 and the reauthorization of the CFTC.

With your permission I would like to submit my written testimony for the record and I will briefly summarize it for you.

It is abundantly clear that H.R. 2869 seeks to send a message to the public that Congress intends to act swiftly and firmly to rectify perceived defects in the regulation of futures markets.

We do not dispute the value of this message. Although we believe that the allegations of abuse in our markets are more a matter of perception than fact, it is undeniably in our interest to ensure that the public confidence in the integrity of our markets is maintained.

While we support the message, as well as the concept of strengthening the regulatory system, we differ fundamentally as to the means chosen to achieve those objectives.

For the first time, the bill seeks to impose congressional mandates in a level of detail traditionally reserved for the CFTC and the exchanges, who are the experts familiar with industry practice, customer needs, emerging technology and all of the other practical realities of day-to-day life.

The bill ignores many important differences among the regulated markets and the customers that use them. The net result, we believe, would be to weaken rather than enhance the efficiency of the system. These weaknesses would be exploited by our overseas competitors who are actively developing look-alike contracts and attempting to take our business overseas.

In the final analysis, under H.R. 2869, the American public would lose the benefits of liquid and efficient markets they enjoy today.

It is both premature and unnecessary to regulate with the detail contained in H.R. 2869. The present regulatory structure, with its flexibility, has allowed the U.S. markets to provide internationally envied risk-shifting and price discovery forums that have been of immeasurable value in achieving price certainty and stability to farmers, oil producers, refiners, industry, the financial community, and ultimately, to consumers.

Mr. Chairman, the system works. Reaction to the press reports in January of a Justice Department investigation into commodity trading in Chicago demonstrates that the system works. Virtually every commodity exchange in the country has performed an extensive review of its own trading rules and practices over the last 6 months.

Many constructive recommendations for regulatory reform have been offered by the NYMEX regulatory review task force and the special review committees formed by the other exchanges.

The essential conclusion of the NYMEX task force was that the appropriate method to regulate against trade practice violations was through rules designed to prohibit improper conduct, an audit trail sufficient to recreate the sequence of trading, surveillance, and compliance systems that identified trade practice violations, and a disciplinary process that both punishes the violator and serves to deter future violations.

On dual trading, however, the task force recognized that dual trading was not a problem in itself. The task force, therefore, did not recommend banning this otherwise beneficial practice merely because of an apparent perception that it created a conflict of interest.

Until studies determine with certainty that such an action would not threaten the efficiency and liquidity of the markets, which will ultimately harm the commercial and public participants that the regulatory structure is designed to protect, the composition of the markets should not be tampered with.

Thus, the task force offered many recommendations for strengthening the regulatory structure, but at the same time, it attempted to ensure that the markets maintained their highly respected pricing capabilities.

We respectfully request that Congress take the same measured approach in its reauthorization of the CFTC. On a positive note, it appears that many of the provisions of H.R. 2869 are consistent with the NYMEX task force recommendations.

We believe that they represent a reasonable effort at fine-tuning the Commodity Exchange Act and system of CFTC and exchange regulations that govern our industry. Our specific comments on those provisions are contained in an addendum to my written testimony.

The dual trading and audit trail provisions of the bill, on the other hand, seem to represent—with all due respect, Mr. Chairman—a "shoot first and ask questions later" approach. They place at risk the efficiency and viability of our markets.

We are fearful of such a method of legislation, because once the damage is done to the markets, it will be irreversible. Accordingly, we respectfully request that the subcommittee reject those provisions of the bill.

If I may briefly digress—I do know I am limited for time—the trading populations on the commodity exchange floors are comprised of three groups of participants, Mr. Chairman: floor brokers who exclusively execute customer orders, floor traders who serve exclusively as market-makers, absorbing risk by trading for their own accounts, and the so-called "dual traders" who may both execute customer orders and trade for their own accounts on the same day.

These three components, though not necessarily comprised of equal numbers of traders, are the three legs of the stool that support the open outcry auction market system.

That system, in turn, provides the most efficient pricing system in the world. On an average day, there are approximately 450 traders on the NYMEX floor, spread among crude oil, heating oil, gasoline, propane, platinum, palladium futures trading, crude oil, heating oil, and gasoline options trading.

The liquidity provided to the markets by dual traders varies depending on a wide range of circumstances. It varies between commodities, times of the trading, and the particular exchanges.

In New York, for example, the limited number of qualified floor traders makes each individual's contribution to the market more significant and less replaceable.

In our crude oil market—in response to Ms. Long's question earlier—at its most active time, 65 percent of our traders are dual traders. They trade 35 percent of the total volume as market-makers for their own account. They also provide a significant amount of brokerage service for customer orders.

I am not going to suggest that if you cut the dual trading leg from the stool that the stool will immediately fall. What I am suggesting is that in light of the vast amount of domestic commerce that relies upon the stability of the stool for support, any proposal that includes a provision for an immediate or contingent market-wide termination of dual trading should not be adopted.

At the present time, there is no evidence that dual trading is an evil unto itself. All that is being said is that the practice creates the perception of a conflict of interest.

We submit that dual trading is not the problem. Like other potential conflicts of interest, it can be regulated through the strict enforcement of rules designated to prevent the abuse of any conflict that may arise.

Mr. Chairman, two proposals have been floated to address the perception problem associated with dual trading. The NYMEX's board of directors met early yesterday and would like to offer up a third proposal which our sister exchanges in New York, COMEX, and the New York Cotton Exchange, cotton agree in principle, and our sister exchange of Coffee, Sugar and Cocoa will consider.

The two pending proposals, offered by the proposed bill and by the Chicago exchanges, tie a market's privilege to have dual trading to audit trail accuracy and/or market trading volume.

We submit that this is the wrong approach. If there is a lack of confidence in the ability to police the markets to protect the public, then strengthen that ability. The punishment of banning dual trading will hurt market participants, not help them. It will make markets less efficient and drive up the cost of doing business.

For these reasons, NYMEX—and as I indicated, with the understanding in principle of our sister exchanges—offer the following alternative proposal:

(a) Congress should not legislate, but mandate that the CFTC, with the full consultation of each exchange, shall determine an appropriate standard for each exchange, to ensure the accuracy of the exchange's audit trail. The CFTC shall take into account the strengths and unique characteristics of each system's method of audit trail creation.

(b) The Commission, with the full consultation of each exchange, shall develop criteria to determine whether each exchange is in compliance with its standard.

(c) To ensure that the traders on the floor of the exchange, who actually initiate the audit trail, are held to the highest standards, Congress shall mandate that the Commission, through regulation, shall require exchanges to adopt rules mandating each floor member to adhere to strict, objective standards for audit trail accuracy.

The exchange rules shall provide specific and harsh sanctions for failure to comply, including, ultimately, the loss of dual trading privileges and/or suspension from membership.

We believe that this proposal, more than any we have heard to date, most directly confronts the issues at hand. All brokers should be held to the highest standards in audit trail creation accuracy.

An accurate audit trail is the optimum means to examine the trading of the individual for violations such as trading ahead of customer orders.

Under this proposal, Mr. Chairman, Congress will legislatively ensure the highest audit trail standards. The CFTC will retain its regulatory authority to ensure that the standards are carefully tailored to achieve Congress' goal while preserving the competitiveness of the U.S. futures markets.

The exchange will benefit by being permitted to address the issue in a forthright and direct manner. If an individual cannot adhere to the strict audit trail creation accuracy standard, the individual should be punished.

Finally, and most importantly, with this proposal and the many other surveillance and compliance improvements that are being implemented, the institution—meaning the exchanges—and the trading public benefit from systems capable of detecting trading abuses and by retaining the most liquid and efficient futures markets to conduct their hedging and price discovery.

On top of that, Mr. Chairman, Congress will have ensured that each participant in the process is fully accountable for the integrity of the system.

I thank you for your time and consideration. I welcome any questions you may have.

[The prepared statement of Mr. Guttman appears at the conclusion of the hearing.]

Mr. ENGLISH. Thank you, Mr. Guttman.

Mr. Corn.

STATEMENT OF BENNETT J. CORN, PRESIDENT, COFFEE, SUGAR, AND COCOA EXCHANGE

Mr. CORN. Thank you, Mr. Chairman. Good afternoon. My name is Bennett Corn. I am the president of the Coffee, Sugar and Cocoa Exchange in New York City.

I have already provided the subcommittee with my written testimony. I will now briefly summarize some of the principal issues we especially wish to bring to your attention.

Our exchange, which has been in existence since 1882, is the preeminent market in the world for trading futures and options in coffee, sugar, and cocoa. Our contracts are heavily used by commercial interests engaged in the production, exportation, distribution, and processing of these three commodities.

We are and always have been dedicated to maintaining the highest standards of integrity in our markets and over the years we have made major commitments of resources to that end.

This has been done as a matter of discharging our self-regulatory responsibility. It has also been done as a matter of enlightened self-interest. This exchange operates with powerful competition from eight rival exchanges overseas, most notably the London Futures and Options Exchange, which actively trades futures on coffee, sugar, and cocoa.

It is very important for us to maintain marketplaces of the highest quality, for if we do not, it is a very simple matter for our largest customers simply to take their business overseas.

In other words, we have the same goals as the subcommittee. We have to. Our livelihood depends on it.

We are very concerned, however, that in a well-intentioned effort to benefit the trading public, the bill presently pending before the subcommittee, H.R. 2869, will actually have the opposite effect.

In some of its most important provisions, the bill proceeds from an unproven and, we believe, incorrect premise. It then attempts to solve a problem which has not been shown to exist, and to do so in a way that could seriously damage the U.S. futures markets instead of strengthening them.

Section 101 of the bill would in effect ban dual trading in markets having an average daily trading volume of 7,000 contracts, unless the relevant exchange can show that its audit trail satisfies requirements that may well be impossible to meet.

We would be affected by this provision in that at present our sugar futures trade well over 7,000 contracts per day, while coffee and cocoa futures trade just under that amount.

Dual trading plays a very important role in our exchange. A quick preliminary survey indicates that in our sugar futures market, over 50 percent of the floor traders are dual traders, and those dual traders accounted for as much as 80 percent of the volume on the trading days we reviewed.

If dual trading were banned, trading volume could be significantly affected. That, in turn, could reduce liquidity and thereby injure our markets.

In our case, the problem would be compounded by the fact that a loss of liquidity will make our foreign competitors more attractive. It is premature to adopt a ban on dual trading at this time.

The subcommittee staff has indicated that on the basis of its investigation, it did not consider dual trading to be a serious problem since, among other things, it is one of the easiest abuses to monitor for and to detect.

The CFTC presently is conducting a thorough study of dual trading. The GAO is conducting a study of the futures markets, and the U.S. attorney in Chicago has been reported to be conducting an investigation of certain trade practices.

It would make far better sense to wait until the results of those studies and that investigation are released before deciding whether any legislation regarding dual trading is warranted, and if so, what the precise nature of that legislation should be.

Nevertheless, if the Congress concludes that the protection of the U.S. trading public requires the abolition of dual trading, then the conclusion should apply as much to trading on foreign exchanges as on U.S. exchanges.

In other words, if dual trading is to be banned, then no one should be permitted to solicit or accept orders from U.S. customers for execution on foreign exchanges that permit dual trading.

On a separate point, the bill would direct the CFTC to exempt any exchange from the dual trading ban if they can show that its audit trail can detect any and all instances of trading violations which the Commission determines to be attributable to dual trading, and is fully verifiable.

We have in place a tight audit trail procedure that has been extremely effective. We are constantly striving to improve it and we expect that we will soon meet the performance standards set by the CFTC.

However, the standards set forth in the bill may well be impossible to comply with. There is no system we are aware of in being or on any drawing board that can detect any and all instances of any violation.

Furthermore, there is no indication whatsoever as to what it means to require that a system be "fully verifiable." The bill is structured so that an exchange would be banned from dual trading during the period it takes for the CFTC to determine the adequacy of its audit trail, a period that could last a year or more.

If the CFTC eventually determines that an exchange has met its burden, there must then be a 90-day waiting period after the CFTC reports its findings to Congress. Only then could the exchange resume dual trading, but by that time, liquidity could already have been lost and the harm could already have been done.

The exchanges should be permitted to have dual trading unless and until the CFTC determines that any applicable standards have not been met.

We have a number of detailed concerns which are spelled out in my written testimony. I hope the subcommittee will carefully consider the issues we have raised.

Mr. Chairman, that concludes my oral testimony. I appreciate the opportunity to testify before you today. If you have any questions, I will be happy to answer them if I can, or I will submit the answers later if I am not able to provide them now.

Thank you.

[The prepared statement of Mr. Corn appears at the conclusion of the hearing.]

Mr. **English**. Thank you, Mr. Corn.

Mr. Fink.

STATEMENT OF ROBERT E. FINK, CHAIRMAN OF THE BOARD, COMMODITY EXCHANGE, INC.

Mr. **Fink**. Thank you, Mr. Chairman, members of the subcommittee. I am pleased to have this opportunity to share COMEX's views on the Commodity Futures Improvements Act of 1989.

Mr. Chairman, we would appreciate it if you include in the record of these hearings our written testimony, as well as an addendum, that details our reaction to some of the bill's provisions. Thank you.

Mr. Chairman, more than 6 months ago, when it first learned of undercover operations at its two largest commodity exchanges, the U.S. futures industry embarked on a course to determine whether current trade practices and regulatory methods promote and defend legal and ethical behavior on our trading floors.

The mere possibility that the investigations in Chicago, and subsequently in New York, would reveal undetected misconduct was enough to cause all of us, exchanges and regulators alike, to mobilize in a broad effort of self-examination and reform.

At COMEX, we have always viewed that process as both healthy and necessary. It was evident that despite possible failures in some of its parts, the system as a whole and the means by which it heals itself were working properly.

Somewhere along the way, however, that process got twisted. We have been diverted from the goal of honestly identifying and solving our problems. Investigation has given way to guesswork, analysis has caved in under the weight of assumption, and honest solutions have been undermined by the forces of expediency and compromise.

I am very sorry to say, Mr. Chairman, that we have before us proposals for reform that have as their main virtue the appearance and only the appearance of having accomplished something.

Let me begin with that part of the process designed to identify the problem. Six months after the announcement of undercover operations in Chicago, very little is known about the nature and conclusions of those investigations.

It is difficult to understand how we can be proposing reforms when we have almost no reliable information about the very events that launched us on the course of reform.

Until we know more, it is not possible to say whether any of the potential misconduct is isolated or widespread, nor is it possible for us to determine whether the types of conduct which are the subject of the investigation were already detected by exchanges surveillance programs, and sanctioned through their disciplinary processes.

In addition, as Mr. Corn has pointed out, the CFTC has proposed a schedule of administrative actions that will deal with issues, such as audit trail, dual trading, and the composition of exchange disciplinary committees and governing boards.

We believe that the prudent course would be to allow the work of the CFTC in these areas to proceed to a conclusion. The absence of information from the Federal investigation and the unfinished work of both the CFTC and the exchanges themselves have combined to create an atmosphere in which the problems are poorly defined and the solutions are, in some cases we believe, premature and unfocused.

Instead of being based on hard facts and clear reasoning, some of the current proposals for reform seem to come more from a thirst for action and the perceived need for a quick fix to complex issues.

Our views on the particular provisions of H.R. 2689 are detailed in our written submission. Some of the suggested remedies, such as those dealing with a more efficient CFTC reauthorization, have merit. Others, such as those dealing with the composition of governing boards and disciplinary committees, are worthy of consideration, but should be left to the exchanges if measures are to be anything more than window dressing.

Particularly disquieting, however, is that some of the proposed solutions not only miss their vaguely defined targets, but also inadvertently score a direct hit on vital and healthy parts of the futures trading system.

Chief among these, Mr. Chairman, is the centerpiece of H.R. 2869, the provisions dealing with dual trading and audit trail. Mr. Chairman, the polemics of the dual trading debate have been aired extensively in recent months.

I won't recite again the many arguments in favor of the practice. On the strength of these arguments, though, and in the absence of direct evidence linking dual trading to widespread abuse of customer orders, the industry's system of dual trading should be allowed to continue.

We further believe that the continuation of dual trading for an exchange should not be tied to its audit trail performance. Penalizing an entire exchange for the failure of certain members to maintain an adequate audit trail injures all of its members and customers by restricting a practice that has proven benefits.

If a major purpose of this legislation is to tie the continued existence of dual trading to a verifiable audit trail, we believe that the correct approach is the one emerging from the joint COMEX/NYMEX discussions on the subject.

In this approach, the focus of enforcement would be on those individual exchange members who have failed to live up to audit trail standards established by the CFTC.

It would be the job of the exchange to enforce those standards among its members, and it would be the job of the CFTC to see that the exchanges themselves are carrying out such enforcement. This combination of exchange enforcement and regulatory oversight is in keeping with the original intent of the self-regulatory mandate.

For some months now, COMEX has had before the CFTC a request for a rule change that would allow our exchange to automatically sanction without the benefit of a trial or hearing any member whose time recordation is unsatisfactory.

We are prepared to include in that proposed schedule of sanctions a measure to suspend the dual trading right of any individual member whose violations rise above a threshold established by the Commission.

It is our recommendation that legislation be enacted that would require all futures exchanges to implement this type of program. We believe that this is the most direct and the most effective means of dealing with the issues.

COMEX believes that an effective audit trail is a critical element in the detection of misconduct on its trading floors. We also expect that if we as an exchange fall short of the standards required by the CFTC, we will be sanctioned under the existing regulatory mechanism.

We are aware also that if we fail to meet acceptable standards on audit trail or any other measure, for that matter, or if we fail to enforce our own rules in any way, we are subject to the punishment of sanctions up to and including the revocation of our right to exist as a contract market.

Mr. Chairman, the central question before us is whether the exchange with CFTC oversight can properly discipline themselves. As I have stated in other testimony, the experience at COMEX tells us that it can. It can if the exchange places rule compliance high on its list of operating priorities. It can if it endows its compliance force with independence of action, that places it beyond the influence of any member or special interests, and it can if its disciplinary committees impose sanctions that make the clear statement that no matter how big or small the violation or the violator, misconduct will not be tolerated.

There is nothing quick or glamorous about these measures. They are the standard elements of any good rule enforcement program. Coupled with the enhanced vigilance of the CFTC, they provide the only sensible way to get where we all want to go—the elevation of industry practices and the promotion of legal and ethical standards.

Thank you very much, Mr. Chairman.

[The prepared statement of Mr. Fink appears at the conclusion of the hearing.]

Mr. **English**. Mr. Fink, I find your interpretation in regard to what Congress intended or what Congress should do, or what Congress' role is to be rather interesting.

I noticed in your testimony on page 3—and I quote—you state:

> The precedent of congressional involvement in the hands-on regulation of these markets, prior to CFTC action, is not a course that was contemplated when the CFTC was established and is a course that has not been followed to date.

I noticed on page 12, you state, "Congress should not be legislating to combat a perception."

On page 19, the third paragraph dealing with disciplinary committees and the make-up, you state that "we believe that this issue of committee composition is not a proper subject for Federal legislation."

I guess, Mr. Fink, I need to explain to you a little bit about how the Congress operates and how this law came about. When this legislation was created, the whole concept was that it would be reauthorized as a commission, to make sure that the Commission was carrying out the will of Congress the way that Congress intended.

The whole concept behind that is from time to time to review and make sure the Commission has been carrying out its duties as it should be. As far as the issue of dual trading is concerned, Mr. Fink, I want you to understand that this is something that has been underway for 15 years, off and on, a study has been underway for 15 years.

So this is not something that the Congress on the spur of the moment has thought up, nor this subcommittee. This subcommittee has made it very clear that we intend to protect the public's interest, we intend to take action.

The real question that we come down to is not a question of whether the U.S. Congress, in particular this subcommittee, has jurisdiction and the responsibility to deal with this matter. We intend to do it because we see that as our responsibility.

So, I appreciate your opinion with regard to what the Congress should or should not do, but I think you should understand right off the top that we see this is our responsibility, and if at any time and in any way we do not think that the CFTC is carrying out its responsibility in the way that it was intended, nor in the way that the Congress feels that it should be, the Congress definitely has the right, and that is the bottom line, Mr. Fink.

Mr. **Fink**. Thank you for that chastisement, Mr. Chairman.

Mr. **English**. Mr. Coleman.

Mr. **Coleman**. Mr. Corn, I think your comments about banning dual trading in this country under certain circumstances, that no orders could be filled for U.S. customers, and where foreign exchanges do not have a similar ban, some sort of reciprocity would be in the order, something that we might want to take a look at and see if it is practical or not.

But if we get into that game, I suppose then every time that we do or do not do something, that they might do at another exchange or another country, we might be getting ourselves into a real fast loss here that we may not be able to control I do not know.

You mentioned something here that we have not seen before and I think we have to consider.

Mr. Corn. We just raised to your consciousness the concern of public protection should cut across the entire playing field where U.S. citizens will be participating in markets, especially those that compete with U.S. markets, and it could be to the detriment of the U.S. markets.

Mr. Coleman. Mr. Fink, the COMEX's accuracy of its audit trail is what?

Mr. Fink. I believe the number the last time that we had a rule enforcement review is 87 percent, sir.

Mr. Coleman. I understand that it varied between 84 and 89, and that the recent period of review actually was the lowest period.

What have you done to increase the accuracy of that audit trail?

Mr. Fink. We have taken two major steps. One is to raise this issue and the level of consciousness of our membership. We have made it clear to them through notices, through disciplinary actions that have been imposed by our supervisory committee, that the exchange will not take lightly any member's failure to properly record his trades.

In addition, we have, as I mentioned in my testimony, made a request to the CFTC in order to expedite the entire process of penalizing those people who have failed to properly record their trades, to impose a schedule of summary actions that would subject them to punishments without the benefit of any long and delayed hearings.

Mr. Coleman. Under the current scheme of things, what is the incentive to your exchange to increase this percentile of accuracy?

Mr. Fink. Obviously, we are under the pressure of the regulatory authorities who conduct routine rule reviews of our recordation systems. They have from time to time prodded us on to higher standards since the rules became effective in 1986.

We have, in addition to that——

Mr. Coleman. Have they taken any action against you?

Mr. Fink. They have not taken any action against us as far as I am aware.

Mr. Coleman. They have not failed to approve any contracts on the basis of your rate?

Mr. Fink. They have not. I do not believe that our performance was in any way regarded as substandard from an industry perspective.

Congressman Coleman, if I may point out, that the provisions initiating the 1-minute time recordation went into effect about 2 years ago. Despite appearances to the contrary, the implementation of the practice is not an entirely easy one.

In markets that are very active and very volatile, recording that extra bit of information was a practice that was not easily adjusted to by our membership. We do the best we can and we continue to improve as time has gone by.

We believe that a goal of 90 percent in the short term is an easy target, and we expect to continue to improve in the long run. That spur to improvement is being imposed on us, not only by the CFTC, but is being initiated on our own behalf because we feel it is in the best interests of our customer body to make sure that an audit trail is verifiable.

Mr. COLEMAN. Well, I think all three of you have a similar view of this issue, and yet all three of you are concerned about things moving offshore.

It seems to me that it would be very easy for you to counteract that by increasing the integrity of your individual markets so that they are above reproach and suspicion and question. By putting in place whatever it costs to put an audit trail in that would maintain the highest accuracy, instead of having to be prodded by the Commission or we having to do this by legislation would be the best action.

Mr. FINK. I believe you are right. COMEX believes you are right, and as I said, not only have we been prodded by the CFTC, but we have initiated our own measures to get that improvement in place.

Mr. COLEMAN. I must say that all three of you have similar views, but, Mr. Fink, you have a way with words that Mr. English has not chastised enough. It would be interesting to see your next testimony before our committee because I have never heard somebody go out of their way to throw sand in our face here as we are trying to work on this legislation.

The other two gentlemen had similar views, but they at least I think made their presentation in a fashion that one should, and not try to be confrontational or argumentative. I would just suggest that you might take a cue from these other gentlemen when you come up here again. It is much better to do it that way.

We understand you hold views that are sometimes emotional. We run into this all the time with these issues, but I just think that you ought to do it in a different fashion.

Mr. FINK. Congressman Coleman and members of the subcommittee, I apologize if my remarks are interpreted as being impudent and/or uninformed. If they appear that way, they stem—their flavor stems entirely from a very strong feeling on the part of myself and the part of the exchange, that there are important issues at stake here. We may have made an overaggressive attempt to defend them.

Mr. COLEMAN. Let me also say to all of you that we are very mindful of your concerns, and we have tried to address those. And, yes, we are operating in an imperfect world and yes, we do not have the study yet from the Commission, and yes, there has been one going on in some fashion I guess for 15 years, and yes, we do not have any indictments in Chicago yet, and yes, we have also provided gaping holes for people to drive a mack truck through here if you so desire.

So, we are trying to be fair at the same time, and I do not think that there is anything in this bill that is so onerous that it is going to put people out of business, or move things offshore, or make your life miserable.

Dual trading! We have all these things in here for the Commission to recognize and to look at and to be concerned about, and to provide exemptions for, and I think that the time has come—and you all have to go outside the framework of this committee and subcommittee and recognize that when we go to the floor of the House, there are other people who are interested in this subject, who are lying in wait down the hall from here, who would love to have you in front of their committee right now, and they do all sorts of interesting bills, and so forth, and may in fact have amendments to this bill waiting, I do not know.

So, I would caution everybody who wants to come in and rip up this legislation. We are open-minded about suggestions, we know we do not have a perfect product, but to come in here and just suggest that it is, as Mr. Guttman said here earlier, and others, that somehow the premises are misshaped and put the cart before the horse, and all this other stuff, we have tried to balance that off with these exemptions, giving the Commission flexibility, and to recognize those shortcomings in any piece of legislation.

Thank you.

Mr. ENGLISH. Let me also say at this particular point that I have taken note of the fact that each of you three gentlemen, and those that have preceded you, have failed to take note of the provision in the law which gives the CFTC the authority, should they find that there is undesirable price volatility, unacceptable widening of the bid-ask spreads, or otherwise threatening to the public interest provisions, gives the CFTC that authority to make that judgment not to take that action.

It seems to be failed to be recognized or appreciated, and I am going to be listening with great interest as far as the testimony from other exchanges and other interested parties. If that fails to be recognized and understood, if it is, in other words, an insignificant feature, if it has little meaning, I will offer an amendment to strike it, and we will move on from there.

Ms. Long.

Ms. LONG. Thank you, Mr. Chairman. I really do not have anything to add except to say that if the system were working as it should be, and in the best interest of the public, we would not be holding these hearings and working the long hours that we are working trying to find meaningful solutions.

Mr. ENGLISH. Mr. Tallon.

Mr. TALLON. Thank you, Mr. Chairman.

Mr. Corn, you talked a little bit about and certainly stimulated my interest and Mr. Coleman's interest about the overseas markets and how they compete with your exchange, and I think that we have determined through testimony today that they do allow dual trading.

Could you elaborate on that a little more?

Mr. CORN. Well, there are approximately eight foreign exchanges that compete with the Coffee, Sugar, and Cocoa Exchange. The preeminent would be the London Fox which trades in coffee, sugar, and cocoa.

The coffee and cocoa contracts are approximately the same size in overall volume as ours, and sugar, we are significantly larger than they are.

In the last few years, the London Fox has made significant changes to their contract to be more competitive with ours. In particular, they went from the sterling contract to a dollar contract because world sugar is priced against the dollar.

Most recently, the London Fox introduced an amendment to their contract to add Cuba as a delivery point, which is against the law here in this country. Again, the reason was to create a more competitive situation against our marketplace.

The major commercial users of our market are the same major commercial users of their market, just as they are with the Paris Bourse which is now part of the MATIF. They have direct communications to those marketplaces, like they do to ours.

I think the fact that our market has grown in stature and volume over the years is contrary to some of the points I have heard here, where people are indicting what is happening on these markets, are making comments that there is something wrong in these markets is just to the contrary.

It proves the point that these markets work, that these commercial interests believe these are the most efficient and effective markets in the world for the products that they are trading.

If that were not the case, we would have lost volume to these markets years ago, and every day that participants, the commercial users and the large public customers are making a free decision whether they will trade here on my market or they will trade overseas.

Now, if I was doing something wrong, and we were not enforcing our rules properly, or in answer to a question Mr. Coleman asked Mr. Fink earlier, the incentive for me to have a good audit trail and to improve it, is the fear that I am going to lose customer business elsewhere.

The integrity of my market is the most important thing I have to offer my marketplace and the people who use it.

Mr. TALLON. Thank you, Mr. Corn.

Mr. Guttman, you mentioned in your testimony, I believe, important differences among the exchanges and we heard testimony earlier from I think the Kansas City Board of Trade, about some of the important differences.

I wish you would elaborate on that a little bit more when we think about what we are going to mandate as far as time stamping or audit trails or accuracy or whatever that we might need to take into consideration those differences.

Mr. GUTTMAN. Well, there are certain procedural differences and there are certain physical differences. If we compare our exchange, NYMEX, or any exchange in New York compared to Chicago, on either one of those two exchanges they have both have approximately 3,000 brokers on their floor which shift among pits, so to say.

In New York, on the New York Mercantile Exchange, we have 450 brokers. In our pits we trade energy, which is crude oil, heating oil, or gasoline, and just like a physical barrel, a refiner takes a barrel of crude oil, cracks it to get two parts heating oil, three parts gasoline.

As he is performing that physical function, he also performs the paper function to hedge those contracts on our exchange, so we have one broker that runs between three rings, getting the pieces into place.

If I take out, based on the certain volume provisions, the dual traders in our pit, and eliminate 150 of those brokers, which will not be able to perform that function of moving between the pits to get my legs of the transactions down, we feel, as an organization, that it will have displacement factors, which is very important to our exchange, and will have the impact that we are fearful of.

You asked Mr. Corn a question, and I would like to echo his sentiments, if I may. We trade energy. A barrel of crude oil literally, in terms of heat, it has a certain value. It is just a question of price differentials between different brands.

We trade West Texas Intermediate Crude Oil. Ten years ago we approached the industry and they indicated to us that they would be interested in creating an energy contract out of this. We did. We started trading crude oil and gasoline.

The international community has come to our exchange to hedge their Dubai, their Brent, commodities that we do not even trade here in the United States, whereas, WTI is our benchmark.

But there is a fine basis point that exists between Dubai and WTI, and they are willing to come into our marketplace and trade WTI regardless of the fact that it is not what they are using. They are using something completely different; 35 percent of our daily volume and open interest is from foreign overseas hedgers.

We indicated or I at least indicated in my statement, the London Exchange has created a parallel exchange to us. Singapore has created an energy exchange, and the government of Singapore allows 10 percent caps on taxes on activity that is hedged off on their shores. MITI, the Ministry Industry of Trade and Finance has now empowered a blue-ribbon panel in Japan to explore their creation of an energy exchange, and now Rotterdam in the next couple of months, is starting up their own energy exchange.

What is happening is the hedging mechanism which we created, we provided under the CEA, is now being cloned, copied and competed with. As Mr. Corn said, it is in our best interest to maintain that audit trail integrity. It is in our best interest for those customers of our marketplace to come in and get a fair price for their participation, but they will not come into our marketplace if for some reason, one, we cannot provide it, or items, such as—again, I do not want to say the 7,000 lots is arbitrary, because the provisions are there—but we do not know at what number one could say that the markets will still maintain their efficiency if we establish these numbers, and the direction that the New York Mercantile Exchange Board has taken the other day to bring to your attention is let's get to the root of the problem.

It is the individual trader on the floor that initiates the audit trail system. He is the first one that writes down the transaction on his pad. That is the commencement of our audit trail system. Let's go to the root of the problem.

These individuals on our floor have a license to earn a living. They have a franchise. They have something to protect. If they know they are threatened, what is about to be taken away from them, we will get their collective efforts through our system.

What we are simply suggesting is hit the guys or the individuals who are causing this possible inability to get to 90 percent rather than penalizing the entire institution from its position in the international community.

Mr. TALLON. Thank you very much, Mr. Guttman.

Mr. Chairman, if I can ask a question that will take 5 seconds to answer.

Mr. Fink, what percentage of the floor traders on COMEX are dual traders?

Mr. FINK. Based on the sample of data that was taken by the CFTC, 43 percent as of late 1988.

Mr. TALLON. Thank you.

Mr. ENGLISH. Mr. Nagle.

Mr. NAGLE. Is there, in the opinion of the three of you, any alternatives that the exchanges, the New York exchanges could agree to with regard to the chairman's position for the mark-up bill on dual trading, and a complete laissez-faire, let's just continue to do what we have done before? Is there a method, is there ground there between the two to meet both concerns over the sanctity of trading and the other?

Mr. GUTTMAN. Congressman, the New York Mercantile Exchange put forth a proposal which we, at New York, find common ground on. I believe that the Chicago exchanges, when you will be interviewing them on Thursday, might give it their consideration.

The emphasis we are now placing on is rather than volume or open interest in any particular month, we will look to target in the individuals that abuse the audit trail efficiency of our markets.

If we can isolate those individuals, those are the individuals which we would look to penalize. If we can do that effectively, we feel that Congress does not have to legislate these items, but set the direction, instruct the CFTC this is where we want to be, this is what we want you to do, and have the CFTC work with each exchange, take a look at their audit trail systems, they are familiar with our audit trail mechanism, and get it up to a point of efficiency that is satisfactory to this particular committee.

Once that is done, mandate sanctions for individuals who cannot abide by those guidelines. We feel that Congress, under those circumstances, can satisfy itself that if the CFTC gets together with the exchanges, creates that efficiency, rules are mandated as to what basically should be the criteria for that efficiency, and ultimately the floor individual who defies or does not live up to what is expected of him, he loses his dual trading privileges and possibly suspended from the exchange.

What we are suggesting is to work it from the bottom up to achieve the objective of what we are looking for.

Mr. NAGLE. Mr. Fink.

Mr. FINK. Congressman Nagle, we agree in principle with the idea that is being suggested by NYMEX. It places the focus we believe in the appropriate place, that is, on the individual member who has gotten us into the soup.

Establishing an audit trail requirement for an exchange as a whole will ultimately wind up measuring just an average. It will do nobody any good if we have an audit trail requirement in which 90 percent of the members have a 95 percent compliance, but there are a small number of members, 5 percent of the members who are at 50 percent.

Placing the blame on, placing the responsibility on, and providing the incentive to the individual broker is the way we think we all should go.

COMEX is suggesting a refinement that suits its particular needs. We are not clear whether it is suitable to the entire industry.

We have had before the CFTC now for several months a request for a rule change that would allow us to impose summary sanctions, fines, without benefit of trial against those members who have failed to properly record their trades and conform to the existing 1-minute requirement.

We are prepared to alter that request for a rule change to have it include a summary, automatic suspension of dual trading privileges if the violations for time recordation rise above a certain level.

Mr. NAGLE. Mr. Corn.

Mr. CORN. Congressman Nagle, I have been spending the last few days of last week and from Sunday on of this week down here in Washington. I did not catch up with the Merc's proposal until about half an hour, about 2 o'clock when we broke for recess.

Since I am only a president, and not a chairman, I have got to go back to my board and bring this to their attention. I am not in a position now to agree in principle, but it is something I have assured Lou and Bob that I will bring to their attention immediately, and we will give it serious consideration.

Mr. NAGLE. Now, is there a problem—if this has been asked before, then just tell me and we will move on—but is there a problem, once you find a violator with the time length that it takes to actually go through and go against that violator and take sanctions against that violator?

Mr. GUTTMAN. On the New York Mercantile Exchange, we have a due process. The violator has a right to appeal it. In fact, it can be appealed right up to the CFTC. As long as the CFTC has, in terms of reviewing it, it could take a 7- or 8-month process.

I could mention a case we have on record right now where an individual floor broker was fined $5,000 for a violation. It went through the disciplinary process on the New York Mercantile Exchange. It has gone all the way up to the CFTC. It is 9 months. It has cost our exchange, in terms of outside legal bills, close to $16,000 through this appeals process for a $5,000 fine.

What we are suggesting over here is if the committee could work with us to achieve this particular proposal, that we employ a limited due process to these individuals, so they could be fined quickly, expeditiously, and not have to take 7 or 8 months to get to the end result of what we intend to do.

Mr. NAGLE. Mr. Fink.

Mr. FINK. Congressman Nagle, we found at COMEX that in the vast majority of cases where we have sought to prosecute people at the exchange for their failure to properly record times, that the data that was used to support those prosecutions were usually cut and dried, and we found that there was no need to tie up our disciplinary processes and no need to prolong the process by having a hearing.

In the vast majority of cases, when somebody has failed to conform to the audit trail standards, it is pretty obvious both to the exchange and to the person that is violating.

Mr. NAGLE. Mr. Corn.

Mr. CORN. I would say about 99 percent of our cases get settled, and I would tend to agree with Mr. Fink that on recordkeeping violations, they are pretty cut and dried, because we are able to get the information right off of the broker's trading card if he is not providing us with the appropriate information.

Mr. NAGLE. One of the things that puzzles me, it seems like everybody has a different auditing system. Is that fair. COMEX is the same as Coffee, Sugar, Cocoa, the same as NYMEX? Does everybody have a different auditing system?

Mr. GUTTMAN. Each one of our exchanges has a different system of creating the audit trail. On the New York Mercantile Exchange, the CFTC asked us close to 10 years ago to come to a 1-minute time standard, which we implemented by using what we call a pit card system.

It is a pit card that is the size of a baseball card, and every trade, transaction by transaction, is recorded by the broker onto this pit card system and submitted immediately to an exchange official for him to clock the proper time of the trade.

That card then gets fed into the computer systems and is displayed on a CRT terminal throughout the floor for peer review by his fellow brokers and the compliance department as to the transaction size, the price, and the time the trade took place.

We feel that this real-time transaction-by-transaction audit trail is very, very effective, but it causes an extra burden upon our brokers because, first, they have to record it on a pad, and take another step and rerecord the transaction on a pit card.

We, based on the CFTC's review, are 85, 86 percent efficient, and it is just really a question which the CFTC, I believe, has to decide whether our 85, 86 percent, which is recorded twice, is possibly more effective than other system at 92 percent which is imputed through some mathematical model in a computer.

So, on our exchange, we are completely different from our sister exchanges in New York, and I assume are different than our fellow exchanges in Chicago. So, it is really an exchange-by-exchange case study as to who might give the information in a more uniform basis.

Again, our 85, 86, on a real time, minute-by-minute submission to an exchange official, might be more accurate than an imputed 92, 93 percent through some mathematical computer model.

Mr. NAGLE. All systems are different, my conclusion is correct? All right. Are you permitted under CFTC rules currently to exchange information on your auditing systems, do you have a joint commission that studies auditing systems? Is there a joint commission between yourselves and the Chicago people?

Mr. GUTTMAN. We have a joint compliance effort in terms of coordinating our compliance activities amongst the exchanges, but I do not know of any joint efforts in terms of computerization.

We run our systems on a Tandem, I believe that COMEX runs theirs on an IBM. Some other exchange might run it on Digital Equipment. The hardware and the procedures, the way we gather the information are different.

Mr. NAGLE. The thing I was curious about—and as Mr. Fink and Mr. Corn responded—if somebody is building a better mousetrap, do CFTC regulations currently enable you to exchange that information about enhancements and auditing capabilities, and are you doing it, and do we need to do anything to enable you to do it?

Mr. FINK. I do not think there is anything that prevents the sharing of information on the audit trail systems. As far as COMEX is concerned, I do not know that we are unique, but we are one of the only exchanges in the industry that requires the manual recordation to the minute of both sides of the transaction by the broker when the trade takes place.

In addition, as a result of a trade processing system that we have installed over approximately the last 2 years, we are probably unique in that I believe COMEX captures more data, captures all of the data associated with any transaction, faster and more accurately than any exchange in the country.

We require the collection of our trading cards every 15 minutes, and as I mentioned earlier, the recordation to the minute of every trade when the trade actually takes place.

There are significant differences among the exchanges, but nothing prevents us I suppose from sharing the information.

Mr. NAGLE. Mr. Corn.

Mr. CORN. Congressman Nagle, the methodologies of trading are different on each exchange, so the audit trail systems that exist in Chicago, that may work very well for them, do not necessarily work for the exchanges in New York, and to the extent that there are also different trading methodologies in New York, one audit trail system may work well for one exchange, and not for the other.

We use an imputed time system for our audit trail system, which in some respects is similar to what the Chicago Mercantile Exchange uses, but ours is a broker-driven input as opposed to an FCM input.

In addition to that, we require every broker to sequence on prenumbered, prelined trading cards, every transaction that the broker does for his own account and that for his customer, in the sequence in which he does the trades.

We are able then, without putting aside the computer aspects of it, we can reconstruct, looking at trading order tickets and other information, plus the trading cards, the exact sequence of the broker's trading for his own account against that of any other customers.

As far as sharing information, that is an ongoing thing, but I think that there are differences in how we trade, and that what may be applicable and work on one exchange, may not work on another.

Mr. NAGLE. My time is gone. I apologize. I was in a markup for the NASA authorization bill. I will review your testimony. I read most of it this morning. I thank the chairman for his indulgence.

Mr. ENGLISH. Thank you. I appreciate it.

Thank you very much. I appreciate your testimony.

Our last witness today is Mr. Robert L. Isaacson, who is vice president of the National Association of Futures Trading Advisors here in Washington.

STATEMENT OF ROBERT L. ISAACSON, VICE PRESIDENT, NATIONAL ASSOCIATION OF FUTURES TRADING ADVISORS

Mr. ISAACSON. Mr. Chairman, after sitting here all day, and it is tough being the clean-up hitter, I have eliminated from my statement everything that you have heard before. I'll just get down to the basics, so it will not take very long.

Mr. ENGLISH. Since you are the last witness, Mr. Isaacson, you just go ahead and say whatever you have to say. There is nobody pressing you.

Mr. ISAACSON. Thank you, sir.

I am Robert Isaacson, an independent commodity trading advisor from San Francisco, California. I am here today as vice president of the National Association of Futures Trading Advisors, known as NAFTA.

NAFTA is a national trade association of approximately 150 companies and individuals who manage almost $6 billion in investments for their clients. Our members are registered as commodity trading advisors and commodity pool operators.

Managed accounts and commodity pools provide an increasing popular alternative to direct speculative futures trading by individual investors. Accordingly, NAFTA members are substantial users of the exchanges on behalf of their customers.

NAFTA welcomes this opportunity to share with the committee the experience of its members under the current regulatory framework and to provide views on several of the issues in H.R. 2869.

First, Mr. Chairman, NAFTA enthusiastically supports the proposal for permanent authorization of the CFTC. In previous testimony before this committee, NAFTA has supported measures to extend the reauthorization period for the CFTC. We commend you for this suggestion which would place the CFTC on the same permanent footing as other Federal agencies with similar responsibilities in regulating financial markets.

Turning to specific provisions of H.R. 2869, NAFTA does not believe a prohibition of dual trading is appropriate or necessary at this time. While NAFTA appreciates that unspecified alleged abuses have prompted the proposals to prohibit dual trading, we believe substantial and valid reasons call for better remedial steps.

First, many of the most skillful brokers may choose to trade entirely for themselves, and no longer for customers. Because many money managers execute large orders for their clients, quality execution of trades is particularly important.

Many NAFTA members devote substantial attention to reviewing the quality of order fills and selecting the brokers with whom they place orders.

If a ban on dual trading were to convert brokers into traders, the ability of our members to trade profitably for their customers could be hampered. Such a ban would also reduce the liquidity of the markets. In some cases, this would make it more difficult to enter and to exit positions for customers, and if for any reason volume were to decrease significantly, a dual trading ban would result in large increases in brokerage commission rates.

NAFTA feels that dual trading should be allowed to continue subject to disclosure to customers that a broker intends to trade for his own account. Existing CFTC regulations require just such disclosure to prospective customers of commodity trading advisors and commodity pool operators.

This disclosure would allow a customer to choose for himself without the market having to suffer the cost I have just described.

Furthermore, we believe increased surveillance by the exchanges and by the CFTC, along with technological developments enhancing the quality of audit trails should make all trade practice abuses increasingly rare.

NAFTA believes a prohibition of dual trading should not be implemented until intermediate alternative steps have been tested. The effects of a dual trading ban on market liquidity needs to be evaluated.

NAFTA supports the concept of outside directors on governing boards as a general principle. In fact, the NAFTA board of directors includes an outside director even though we are a private trade association.

However, NAFTA believes no particular merit exists in a fixed 20-percent requirement. NAFTA believes the experience and knowledge of individual governing board members, whether member or nonmember, are more critical to sound decisionmaking and representation of public interests than mandated percentages.

Concerning the 3-day cooling off period, I would point out that telemarketing is not used to any significant degree by NAFTA members. Nevertheless, in the interest of enhanced investor confidence in our markets, we support the concept of such a cooling off period.

NAFTA members are concerned, however, that it would be extremely difficult to implement and police such a proposal. For example, it is not clear to what extent a brokerage firm could rely upon oral issuances from the customer that he was not a first-time customer. What types of evidence would suffice to permit a broker to satisfy this question?

Finally, NAFTA has long supported the development of ethical standards throughout the futures industry. In fact, NAFTA views as one of its purposes the enhancement of ethical standards for trading advisors and pool operators and intends to include sessions in this area in its future annual meetings.

Our segment of the futures industry is subject to a broad array of regulations. Commodity trading advisors, commodity pool operators, and their associated persons are required to register with the NFA. Each of these associated persons must first successfully pass a national commodity futures exam.

The NFA conducts regular audits of all NAFTA members. Exhaustive disclosure of recordkeeping and reporting regulations govern commodity trading advisors and pool operators, and pool operators must provide annual audited financial statements to their customers, the NFA, and the CFTC.

These regulations have been in place for over a decade and continue to be supplemented from time to time by NFA compliance rules covering areas such as promotional material.

NFA staff also conduct periodic compliance audits. Comprehensive security regulations also govern pool operators and trading advisors. NAFTA members are thus subject to a broad range of compliance responsibilities. This regulatory framework is considerably broader in scope than applicable to most any other CFTC registrants.

All this leads NAFTA members to believe more vigorous enforcement of existing futures industry regulations may be more effective in preventing abuses than increased regulatory layers of ethics training. This is in large part due to NAFTA's concern that serious problems must be very carefully considered in developing any regulations to implement such a requirement. Would this requirement create a financial hardship on individuals in smaller firms, for example, by imposing travel to central locations for initial or refresher training sessions?

For these kinds of reasons, NAFTA urges extreme care in crafting any ethics regulations, and we commit our full assistance to the CFTC for that purpose. In fact, NAFTA could undertake to provide any such required training for its members and would encourage Congress to suggest such an approach for members of NAFTA and other similar trade associations.

Mr. Chairman, we appreciate the opportunity to present the views of our association, and I will be happy to answer any questions.

[The prepared statement of Mr. Isaacson appears at the conclusion of the hearing.]

Mr. English. Thank you very much, Mr. Isaacson. I appreciate that.

I did not hear you make any reference to the provisions that we have in there, for instance, the provision that says that customers, if they so wished their broker to continue in the capacity of dual trading, they can give that approval. That decision rests solely with the customer.

We feel that he should have that right to make that decision. We also, of course, did not hear any comment with regard to the elements contained in the bill that states that the Commission has the right to suspend dual trading, or should reinstate dual trading on any contract, or not even ban dual trading on any contracts should they find that it creates undesirable price volatility or unacceptable widening of the bid-ask spreads, or otherwise threatens the public interest—public interest, that is pretty broad.

I guess I am having trouble understanding why you and others did not make reference to this. It would appear to me that these would be elements that you would want in this legislation, that you would want to continue to see included.

Mr. Isaacson. Our perspective may be slightly different than the typical speculative customer who may feel he has been hurt by dual trading in the past.

Most of us who have been in the business for some time, and are managing rather large sums of money, know the brokers on the floor that we are doing business with and have done business with over a long period of time.

One of the processes that we go through as we select a broker to execute our trades is we get to know that person. And we have a feel for his ethics. Our concern is not that dual trading may be wrong or may be right. Our concern is that at some point it impacts on the people we are doing business with on the floor, it impacts on the customers we represent.

Mr. **English**. Let's follow that a little bit. Let's say that you have got this broker out there and he trades for himself, as well as for his customers. This legislation becomes law. Basically, he then sends you a piece of paper which states that you sign off and agree that you recognize and understand that he is trading both for himself and for you, and that you give him the authority to continue to act in that guise.

Now, tell me what is different, then, from that point on in the way he treats you and the way it is today.

Mr. **Isaacson**. There is nothing different from our point of view. I guess the major problem we have with the elimination of dual trading is that it may not eliminate some of the other problems that exist on the trading floor. Some of the other problems that exist will likely be eliminated as a result of better audit trails.

Mr. **English**. That is fine and we are certainly willing to go after other problems, but we are dealing with this particular problem right now.

Mr. **Isaacson**. Yes, sir.

Mr. **English**. I guess what I am trying to walk you through, I am trying to find exactly where this problem is that exists.

Now, you have on the one hand, for you, you say it does not make any difference, because you know your broker, you do not care whether the guy is trading for himself and for his customer at the same time, but we have got other customers that may very well object to that, and should they not be given the opportunity to say no, I do not want this guy that I am doing business with to trade for himself at the same time he is trading for me, should they not have that right?

Mr. **Isaacson**. Sure. We think that they should have that right.

Mr. **English**. So that provision, you would agree with?

Mr. **Isaacson**. That provision we would agree with. The way it should be structured perhaps is that if there is a floor broker who is dual trading and he says he is dual trading—and my counsel's interpretation may not be your interpretation—but once a person starts dual trading, and they tell the customer they are dual trading, that is it. There does not have to be any ongoing type of communication with the customer about dual trading.

Mr. **English**. Once he has signed off and made that determination, yes, that is correct. Certainly the broker can go back and forth. He may decide one day he wants to trade for himself and another day he is going to trade for the customer, that is fine.

Mr. **Isaacson**. We have no problem with that.

Mr. **English**. Then, the next question, I would assume that any problem that you have with regard to any impact it might have on the markets.

Mr. **Isaacson**. We have a problem if it involves liquidity, if for some reason it puts other traders out of the market, if it puts dual traders out of the market who do not represent commodity trading advisors and pool operators.

Mr. **English**. Then, the question with regard to liquidity, does that then not also fit into the action that the CFTC can take with regard to allowing dual trading when we talk about undesirable price volatility, unacceptable widening of the bid-ask spreads, or otherwise threatens public interest?

Certainly I would not think the CFTC would think that the elimination of liquidity is in the public interest, would they?

Mr. ISAACSON. No, I do not think so.

Mr. ENGLISH. So, that takes care of that problem, does it not?

Mr. ISAACSON. Yes, sir.

Mr. ENGLISH. Then, tell me where the problem is.

Mr. ISAACSON. Our problem, I think is more in a paperwork type of situation and a logistical type of situation.

Mr. ENGLISH. Paperwork?

Mr. ISAACSON. From our perspective, we do not think the system is not working. We think the system is operating just fine right now. We do not have a problem with the way trades are executed.

Mr. ENGLISH. I guess, then, what you are telling me is you do not really have an objection to what we are doing in this provision, I mean there is nothing that you come up with to say that in any way this is going to cause a problem, it is basically you prefer things are as they are, as opposed to going to a new approach, is that right?

Mr. ISAACSON. We do not think the new approach necessarily eliminates the problems that we see on the trading floor on a day-to-day basis.

Mr. ENGLISH. But you agree or at least you cannot come up with now any problems that it creates?

Mr. ISAACSON. No, but what we are saying is you are instituting a new measure that is different, and we are not sure what the impact is going to be: If it has a substantial impact on our clients, because liquidity is impaired——

Mr. ENGLISH. But we have already given the CFTC that authority to deal with that, have we not?

Mr. ISAACSON. If they act rapidly.

Mr. ENGLISH. And if the CFTC has any doubt in their mind, certainly they are not going to do anything that is going to be harmful to that contract, are they?

Mr. ISAACSON. Harmful to the contract, maybe harmful to liquidity, I'm not sure. I'm not sure how fast they would make a decision.

Mr. ENGLISH. If they have the authority to do it, they can do it instantaneous, could they not?

Mr. ISAACSON. Well, as Congressman Coleman said, sometimes the reality of idealism is not always there. Sometimes it may be idealistic that they will act right away. However, it may be a significant period of time before they act, and if that affects liquidity, and it affects some of the commodity pools or some large sums of money that are being managed in the market, even for a short period of time, it can have a detrimental impact on NAFTA members and their clients.

Mr. ENGLISH. So, basically what we are faced with, in your opinion, the question of the tradeoff comes down to trading off the customer's right not to use a broker who is involved in dual trading, to not to take action to do anything that may eliminate some of the potential abuses.

That is on one hand, but on the other hand, in your opinion, what outweighs that is the fact that CFTC may not act responsibly?

Mr. ISAACSON. I am not saying they may not act responsibly. I am saying they might not act in a timely manner.

Mr. ENGLISH. That would be responsible, would it not?

Mr. ISAACSON. They may have a different opinion of what is responsible than I do.

Mr. ENGLISH. Mr. Coleman.

Mr. COLEMAN. No questions.

Mr. ENGLISH. Ms. Long.

Ms. LONG. No questions.

Mr. ENGLISH. Mr. Nagle.

Mr. NAGLE. Just for my own education, if I could.

If I approached your company and said that I wanted you to handle my purchases, and I did not want someone handling the purchases who is engaged in dual trading, would that be done currently?

Mr. ISAACSON. We are more similar to an investment advisor than a floor broker. You would come to me and say I would like you to manage my futures account and I have a preference for what broker to use. We would call the broker that you said to use.

Mr. NAGLE. In the industry itself, if I called for a broker and said I want you to trade my account for me, I do not want you to engage in dual trading, is that done? In other words, is there additional cost, under current practices of the various exchanges, if I request that dual trading not take place, is there an additional cost to me, do I have to pay an additional fee, or is there an impediment to my getting access to the markets?

Mr. ISAACSON. I think that depends on how big of a client you are. If you trade one contract of wheat and one contract of corn, and you went to the brokerage firm and said I would like to know if the broker was dual trading or not, they might give you that option, they might not. It might not be cost effective for them to do that.

I would guess the bulk of our members' feeling is that when you use a person who is not trading for themselves, they are not as experienced nor as qualified as someone who is dual trading.

Mr. NAGLE. Hang on just 1 second. I thought you said——

Mr. ISAACSON. If you are referring to where I spoke about extra cost, added cost of dual trading, we feel that there could be added costs because floor brokerage would likely increase.

Mr. NAGLE. "NAFTA believes dual trading should be allowed to continue subject to disclosure to customers that a broker intends to trade for his own account. Existing CFTC regulations require just such disclosure to prospective customers of commodity training advisors and commodity pool operators. This disclosure would allow a customer to choose for himself without the market having to suffer the cost I have just described."

I guess my question is currently: If I am the average farmer out there with 100 acres of corn, and I want to go in and use the market, if I am raising 1,000 hogs a year, marketing 1,000 hogs a year, can I without extra cost, without extra penalty, or without difficulty, get access to a trader who does not engage in dual trading?

Mr. ISAACSON. I cannot answer that question. That is a different area than we deal in. If you came to my firm and you wanted to open an account with me as a trading advisor, I would have to give you about an 18-page risk disclosure document that would tell you among other things if we were trading for our own account.

I would imagine if a farmer wanted an individual that was not dual trading on the floor he would probably pay some premium somewhere along the way.

Mr. NAGLE. Let me ask you this. If you went to the disclosure requirement, would that cost then be passed on to the customer who opts not to have a trader engaged in dual trading, as you envision it under your testimony on page 4?

Mr. ISAACSON. I think there is a potential for increased commission cost, increased cost to the customer if he uses a trader who is trading just for clients, and is not dual trading.

Mr. NAGLE. In terms of the action that this committee should take—I listened to Mr. English's questions very closely, and what Mr. English has basically done has required an affirmative act on the part of the customer to permit dual trading, and the customer has to say it is OK to dual trade—would you envision under that, that would be additional cost to the customer?

Mr. ISAACSON. I would envision that if the customer said I want a trader who is not dual trading, I want a floor broker who is just trading for customers, that there would be increased cost to the customer.

Mr. NAGLE. What, in your mind, would be the difference between requiring an affirmative act by the customer to permit dual trading and an affirmative act by the customer not to permit dual trading? Would there be any difference?

In other words, instead of my being required to say yes, you may dual trade, I could say, unless I said I do not want you to dual trade, you would be permitted to do so, is there a distinction there in terms of either cost or——

Mr. ISAACSON. No, I think that a customer should be alerted to the fact if there is a potential conflict of interest and the cost may be more. The customer should be made aware of that.

We think that full disclosure is the way to go. Then let the customer make his choice. I am not understanding your question because——

Mr. NAGLE. No, you are, you are doing a good job.

Let me ask you this. It is the last question. I may take you on this one beyond the area of your expertise. But if I wanted to trade on COMEX currently today, and I did not want to have dual trading, is there an additional cost for me to do that by the broker?

Mr. ISAACSON. When you say an additional cost, do you mean an additional commission cost?

Mr. NAGLE. Yes.

Mr. ISAACSON. When I say additional cost, I mean there may also be additional hidden costs because the person who is trading only for customers may not be as effective in getting good execution for the client as the person who is dual trading.

Mr. ENGLISH. Why is that?

Mr. ISAACSON. Because the person who is dual trading has the potential of making income off trading for his own account. A person who is trading just for customers, who is getting 50 cents or 75 cents or $1 a trade, is doing that because he may not be as effective in the pit as a person who also trades for his own account.

It is the law of supply and demand, and he is going to be the most effective in gaining income for himself.

Mr. NAGLE. I do not understand why that is.

I yield to the Chairman.

Mr. ENGLISH. I guess the only point that I want to make, of course, that would be your perception as it is now, the feeling that that is the way it is now. Would it not be true, though, that if the provisions of this legislation became law, then each day that same broker is going to have to decide whether on that day he wants to trade for customers or whether he wants to trade for himself?

Mr. ISAACSON. My perception is that on the floor——

Mr. ENGLISH. In other words, we are going to have all these good traders that are going to be available to be able to trade for customers, so in effect, we are going to be helping all these fine customers out there that do not want dual traders.

Mr. ISAACSON. My perception is that I want the person that is trading for himself also because I have a belief that he is a more effective broker than one who is just trading for customers.

Mr. ENGLISH. But you agree there are people on the other side, who take the other side and say, hey, I do not trust that guy who is going to be trading for himself at the same time he is trading for me? If it comes down to the interest as to who is going to get the good deal and who is not, you know, he gets the good deal and I get stuck, and I never know the difference.

That is what the fear is for some people, correct?

Mr. ISAACSON. That is right.

Mr. ENGLISH. So, it is opinion.

Mr. ISAACSON. That is right, just so the customer knows what he is getting into. We have never taken the time to quantify it, and we certainly do not have the resources to quantify it—but if you look at trading advisors that are putting orders through several different brokerage firms, the same orders at the same time, there might be a way to quantify the effectiveness of traders. Many trading advisors keep a record of which brokerage house gives them the best fills. You could perhaps look and see which brokers were dual trading.

Mr. ENGLISH. I thank the gentleman for yielding.

Mr. NAGLE. I thank the chairman. My time has expired.

Mr. ENGLISH. I guess just one other follow-up on that point. The question comes down as to how to handle the issue on dual trading. We are talking about the way that this bill is written. In exchanges, there may be some contracts where dual trading is allowed, simply because of the volume.

There may be some contracts in which dual trading is allowed simply because the CFTC, for reasons of liquidity, or whatever it may be, feels like that is necessary. There may be some contracts where dual trading is banned in certain times of the year because of the activity and the way that that particular contract—all of that flexibility is built into the provisions under this law. It also states that a person then who is involved in dual trading, if the customers that he has—and I have one, a good friend of my family back in Oklahoma who says gosh, I have been using this same broker for years, I trust him, I believe in him, and I want to use him, I do not care whether he is trading for himself or not, fine, they can go ahead and sign off and they are taken care of.

But for all those people out there who do not know that, who do not feel confident of that kind of a system, all those people who are going through various organizations that are handling them, and putting them together, they do not have any say in this in many cases.

A lot of people do not have any say as to who their broker is, do they?

Mr. ISAACSON. I do not understand. Why wouldn't they have a say in who their broker is?

Mr. ENGLISH. Well, if they are trading with Merrill Lynch or someone like that, now, there, as an individual, I will go in there and they are not going to know who the broker is, are they?

Mr. ISAACSON. Well, I would assume they will now if the provisions of the bill go into effect.

Mr. ENGLISH. But I am talking about today, as it is.

Mr. ISAACSON. No, they do not.

Mr. ENGLISH. And they have no say about it today.

Mr. ISAACSON. Probably not, but they do not care enough to inquire.

Mr. ENGLISH. And most people do not, do they?

Mr. ISAACSON. They do not.

Mr. ENGLISH. That is the reality. I guess what I am coming around to, it would appear to me when you add up all these elements, all these provisions, there is a tremendous amount of flexibility in here to meet an awful lot of different situations.

Basically, what we come down to is the bottom line, is that people who do not feel comfortable in having a broker that is dealing for himself at the same time he is dealing for them, they are going to be protected.

It basically says that for those cases—and we are talking about those markets with a lot of volume, a lot of action, fast trading—and whenever we talk about these percentages, when we are dealing about these percentages and we say, well, it has got an 86 percent reliability factor, or even a 95 percent, we are not talking about every contract in every minute of that day.

There is some parts of the day it is probably going to be a whole lot more reliable, and other parts of the day it is going to be nearly as reliable.

If we are talking about abuses that are going to be taking place, the time that it is going to happen is when there is a lot of action most likely, a lot of action, a lot of activity, hard to keep track of, hard to watch, and it is not going to be during the rest of the day.

It may be in the first few minutes of each day, it may be in the last few minutes of each day, and that is basically what this bill and those provisions deals with, is that not correct?

Mr. ISAACSON. A lot of the things that you are referring to in those first few minutes and last few minutes such as curb trading or wash trading are not going to be eliminated by letting the customers make their choice of whether they want a dual trader or not.

I think the only way to eliminate those problems is with better audit trails, increased ethics and more vigorous surveillance of the floor.

Mr. ENGLISH. We agree with you 100 percent. What we are simply saying, though, is that under the dual trading provisions, and whenever you get all these people, and you get a lot of folks going, it is tougher, it is tougher on the system, and places more demands on the system.

All we are saying is, give us a better system, give us a system in which we can make sure that we can identify those kinds of abuses, fine, go ahead and dual trade. I do not have a problem with it philosophically, fine, let's just make sure that we can identify it.

I guess that is where I am coming from at least.

Gosh, I appreciate your testimony.

Mr. ISAACSON. Thank you for listening.

Mr. ENGLISH. You did a good job. It is a pleasure to have you as a witness.

Mr. ISAACSON. Thank you.

Mr. ENGLISH. We will recess subject to the call of the Chair.

[Whereupon, at 5:25 p.m., the subcommittee was adjourned, subject to the call of the Chair.]

[Material submitted for inclusion in the record follows:]

STATEMENT OF HONORABLE NEAL SMITH (D-IA) BEFORE THE CONSERVATION, CREDIT, AND RURAL DEVELOPMENT SUBCOMMITTEE OF THE HOUSE AGRICULTURE COMMITTEE REGARDING CFTC REAUTHORIZATION

July 18, 1989

Mr. Chairman, I congratulate you and the Subcommittee for making the most extensive review and effort since the CFTC was established to determine the amendments needed so that confidence in the integrity of the exchanges will be both restored and warranted.

When the Act was passed fourteen years ago, it would have been just as easy to have passed a law banning futures altogether, but I thought then and still think there is a service to be rendered by properly operated futures markets in those contracts where a genuine economic interest can be served which benefits major segments of an industry without hurting other major segments. The SEC had accomplished a great deal in assuring integrity in the securities market and the futures responsibility could have easily been assigned to their jurisdiction; but I thought it would be better for producers and processors of agricultural products if the shifting of risk for basic commodities were handled by a separate organization with primary interest in those products rather than securities. The principal purpose of the Act was to regulate commodity futures, not financial futures, and that is indicated by the fact the new Commission was named the Commodity Futures Trading Commission.

Since the CFTC was established, it has approved numerous contracts in financial futures and options and devoted proportionately less time and resources to the commodities and has in my opinion not performed adequately with regard to commodities. Although the CFTC has been a disappointment, it has not been entirely their fault. Congress must share the blame because some of the provisions they needed to assure integrity in the markets were removed from the law prior to the final enactment, and under pressure from the exchanges those shortcomings have not been corrected. Again, I congratulate you for making the most extensive and serious effort so far since the Act was originally passed to deal effectively with this important subject and hopefully the latest scandal which has developed in Chicago will help you pass the needed amendments including banning dual and insider trading this year.

DUAL TRADING

One of the most visible problems affecting the integrity of the exchanges and the public's confidence in the markets is the issue of dual trading. Allowing floor brokers to trade for their own accounts at the same time they are executing orders for customers is replete with real as well as potential conflicts of interest and opportunities to cheat customers. However, when the Commodity Futures Act was originally passed, representatives of the exchanges successfully lobbied for an exception with the excuse that it was needed for liquidity. Each time the Act has been reauthorized since then they have sought and received some additional time with the excuse they need time for another study or that they will perfect some improvement in the audit trail. Some even used the excuse that since criminal cheating by dual traders had not been proven, we should assume neither criminal cheating nor rules violations were occurring. Since dual trading was not prohibited and the evidence of fraud and conspiracy was extremely difficult to acquire, criminal acts could not be proven without a major and extremely difficult and costly law enforcement sting operation; but that has now been accomplished so any claim that abuses may not be a problem is no longer an excuse. Others claimed a better audit trail would protect customers but the Exchanges vigorously opposed even modest improvements in the audit trail system proposed by the CFTC. The floor traders themselves have no faith in the ability of the exchanges to detect and prevent cheating as evidenced when 1,000 floor traders two years ago signed a petition to hold a membership referendum on a proposal to prohibit dual trading in stock index futures and options.

Until the old horse and buggy method of dealing in the pits has been replaced by a fully implemented system of computerized trading which permits a customer located in a broker's office in any state to know immediately whether he has matched an offer or his offer has been matched, there should be no more than one exception to a dual trading prohibition; and that is where the exchange is so small or the contract so small that the customer should know the risk that his order is probably being executed by the floor trader who may very well also be trading for his own account. It is now clear that dual trading should be outlawed and I urge the Committee not be lulled into another delay in outlawing dual trading. It should be outlawed now.

INSIDER TRADING

Another area of obvious concern is the lack of a prohibition on the use of inside information in the futures markets in the same way that it is prohibited in Securities markets. The conflicts of interest from the use of inside information that are inherent in futures trading are not limited to floor brokers and activities in the pits. I have a bill (H.R. 603) before this Committee which addresses this problem, which would prohibit insider trading in futures markets much the same as it is currently prohibited in the stock markets.

The law as it has been developed under our various Securities statutes, is based on the unfairness of allowing traders to profit for their own accounts through the use of information that is unavailable to others in the market place. The same type of activity that the securities laws prohibit is not illegal in futures trading and the acts for which people are being prosecuted in New York would not even be illegal in futures.

An official of a futures exchange, an account executive, a floor broker or even the back room staff of a futures commission merchant could use non-public information concerning a large reportable position in futures contracts of customers or the anticipated transactions of others to profit in their own accounts. The corporate officer who is aware of a pending announcement of a large increased sale or purchase of a particular commodity or position in the futures market could use that information to trade in futures for his own account before the information is made public. Hearings I conducted in the Small Business Committee proved some had done so. Since it is contrary to the interest of the company they work for, some companies now prohibit their employees or officers from using inside information this way, but some do not. Whenever one futures trader profits from such inside information, his customer or another trader necessarily suffers an equivalent loss.

The House Committee on Small Business conducted a study into insider abuses in the cattle futures market. That investigation showed that of the $156 million in profits made by large cattle futures traders, $114 million (or 73 percent) was made by potential insiders -- floor traders, officers of brokerage companies and officers of agri-business firms who were trading cattle futures. Those with access to inside information consistently made profits the vast majority of the time and those without access to inside information were consistent losers most of the time. Nine years have passed since that study and seven years have passed since an amendment nearly identical to my current insider trading bill, was passed by the House of Representatives as part of the 1982 CFTC Reauthorization bill. That amendment was ultimately dropped in Conference and another CFTC study of the problem was substituted.

The SEC is vigorously enforcing the law to stop inside abuse in securities in connection with takeovers. But someone with inside knowledge of an impending takeover may not only trade in the affected stock but also may trade in the index futures where there is the potential to make much larger profits; and that is not even illegal. This problem not only involves movement of large reportable positions in agricultural products but now involves financial markets as well. I urge you to incorporate the provisions of H.R. 603 in this years CFTC reauthorization bill.

EXPORT SALES REPORTING

I also request that the Subcommittee give consideration to an additional bill (H.R. 602) which I introduced again this year. It would make important improvements in the existing grain export sales reporting system of the USDA. As we initially learned in 1972-73, and several times since then, accurate, objective, and timely information, becomes crucial to effective public and private decision making in marketing grain. That is the purpose of reporting large export sales to the USDA but the law is inadequate to serve the needs of producers and domestic processors. The current USDA export reporting program does little more than record historical and statistical data. It does not protect producers, elevators and domestic merchants from being ripped off. Foreign state trading companies and the overseas arms of international exporters do not adequately comply with USDA rules, nor will they unless there is leverage through the CFTC.

H.R. 602 would make the export reporting requirements a part of the Commodity Exchange Act administered by the CFTC and require reports to the CFTC instead of merely being filed with the Agriculture Department after the positions in the futures have been taken. This would have the following advantages:

1) Foreign exporter firms, foreign affiliates and subsidiaries of U.S. firms, and even foreign country trading companies who cannot be effectively compelled to comply with the existing reporting law nevertheless use our futures markets to a very great extent to hedge their grain transactions and to speculate with the benefit of the inside information. Any such firm which holds a futures position in excess of CFTC speculative position limits would be required to report significant cash grain transactions to support their hedging exemption from speculative limits. Requiring these additional firms and foreign affiliates which are taking large positions to report would provide a more complete picture of the true demand for these commodities and is necessary in order to know whether they are exceeding the speculation limits.

2) Since the Commodity Exchange Act requires reports of cash grain transactions to support a hedging exemption to speculative trading and position limits, if they filed reports with the CFTC and it were made public an exporting

firm would not be able to cover an entire large grain transaction and take speculative positions over a period of a week or two before our producers, merchants and processors were informed of the new demand.

3) The CFTC could more effectively secure compliance with the reporting requirements than can the USDA. The existing authority of the CFTC to suspend or deny trading privileges on the futures markets for violations of the Act as well as the ability to impose civil fines represents a much more potent incentive for compliance than the small fines the USDA can impose.

Only through reporting to the Commodity Futures Trading Commission can foreign state trading companies and international exporters be required to comply with our law. Only through the reporting procedures passed by the House in 1982 and then dropped in Conference in favor of another study can such a system be enforced. The CFTC needs this information to do their job and is the only agency which can adequately enforce the requirement to report, regardless of the origin of the grain. They could furnish copies to USDA of more timely and more complete information than USDA now has.

American farmers are asked to provide, free of charge, timely, accurate information on how much grain they plant and on how much grain they will harvest. This supply information is disseminated by the USDA, free of charge, to the whole world, including the Soviet Union. It is not too much to ask that the same kind of timely, accurate information about the export demand for grain be provided by international grain traders.

CONCLUSION

I have only highlighted the most visible needs for amendments which are also covered in bills I have had pending before this Committee for several years; however, I know this Subcommittee has examined numerous other less visible but also important possible amendments, and for that I compliment you. The dollar volume in futures now exceeds the dollar volume in securities. The business of shifting and reducing risk in business is very important to commerce in this country and especially to small businesses including farm producers, elevators, and processors as well as all those who are so heavily impacted by shifts in interest rates. You have accepted the important responsibility of making the first comprehensive review and amendments to the Act since it was passed fourteen years ago. I congratulate you on the extensive investigation you have made and your obvious willingness to undertake and make some important decisions in the public interest.

I want very much to work with you to make the needed amendments, but if Congress does not at least ban dual and insider trading in contracts under the jurisdiction of the CFTC and of some of the most obvious abuses are not corrected this year, then I will work with those who want to shift all or most of the jurisdiction to the SEC where those protections are a part of the basic law.

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Testimony of
Dr. Wendy L. Gramm
Chairman
Commodity Futures Trading Commission
Before the
Subcommittee on Conservation,
Credit and Rural Development
of the Committee on Agriculture
U.S. House of Representatives
July 18, 1989

Mr. Chairman and Members of the Subcommittee:

I am pleased to come before you today representing the Commodity Futures Trading Commission to present our reauthorization proposals and to respond to the legislative proposals put forth in the Commodity Futures Improvements Act of 1989. This reauthorization comes at a time when the Commission's aggressive enforcement program -- demonstrated by our participation in the undercover operation in Chicago and the recent investigation in New York -- has focused public, industry, and Congressional attention on alleged abuses in commodity futures trading. Your Subcommittee staff have just completed a thorough inquiry covering all markets and found the self-regulatory systems to be generally sound. The Commission also has conducted a review of oversight procedures and exchange trading practices. Now, this Subcommittee is considering regulatory and legislative changes to even further strengthen the Commission's ability to oversee futures markets.

While the Commission supports the Subcommittee's goals in this area, we believe that Congress has given us sufficient authority in the Commodity Exchange Act to fulfill our mandate to oversee the markets. Thus, we are not asking for major legislative changes at this time although we too are proposing some changes to enhance our regulatory program.

Before addressing the specifics of our legislative proposals and responding to certain aspects of the Commodity Futures Improvements Act of 1989, I would like to highlight some of our recent, more significant regulatory activities:

* The Commission is completing an 18-month review of improved audit trail systems. In 1986, the Commission required exchanges to implement significantly improved audit trails which must determine the execution times of all trades to the nearest minute. While the Commission found that the exchange systems generally were adequate at this initial stage of implementation, we called on the exchanges to develop a plan for achieving improved compliance and for improving the accuracy of source documents used in obtaining execution times.

* In February, after an extensive review process, we approved the Chicago Mercantile Exchange's proposed Globex system for trading CME contracts after regular trading hours. Globex is

the first electronic trade execution system at a U.S. futures exchange.

* In April 1987, the Commission approved extended trading hours for the Chicago Board of Trade (CBT). This rule change allowed the CBT to compete for overseas trading business in U.S. Treasury bond futures and option contracts and in U.S. Treasury note futures and options contracts when it conducted the first night trading session at a U.S. futures exchange.

* In January, we issued an interpretation clarifying that certain hybrid instruments are excluded from the Commission's jurisdiction and proposed a regulatory exemption for other hybrids with option components. Yesterday, we issued a final rule providing a regulatory exemption for such hybrids, and a policy statement regarding the regulatory treatment of certain swap transactions.

* Internationally, we have moved forward by establishing cooperative arrangements with foreign regulators and self-regulators to permit the offer and sale of foreign option products in the U.S. and to permit foreign brokers to market foreign products to U.S. customers without registering with the Commission. We are continuing to establish financial information sharing arrangements with foreign jurisdictions.

* After October 1987 and during much of 1988, we devoted substantial efforts to addressing the implications of the price break in the stock market. During that period, the futures

market regulatory system proved durable and no futures brokerage firms failed. In the past year, exchanges and market regulators have implemented many of the recommendations of the Brady Task Force and the Presidential Working Group on Financial Markets. For example, coordinated circuit breaker mechanisms have been implemented across securities and futures markets; and credit, clearing and settlement systems have been improved to facilitate efficient cash flows.

* Although the Commission has been extremely productive in a number of new areas since the last reauthorization, the ongoing work of the Commission continues to consume our time and attention. An example of such activities was the significantly increased market surveillance, which occurred during last summer's drought. While prices were volatile due to the great uncertainties regarding the impact of the drought on crop yields, no market problems arose at that time that required Commission intervention.

During the drought, I participated on the President's Interagency Drought Policy Committee, chaired by then-Agriculture Secretary Lyng.

COMMISSION'S LEGISLATIVE PROPOSALS

Now I would like to turn to our legislative proposals. The Commission's legislative request consists of five parts that deal with nationwide service of process, international law enforcement, civil monetary penalties, automatic suspension and trading prohibitions for failure to pay penalties, and registration of floor traders. I will review each of them briefly.

The first proposal would amend the Act to authorize nationwide service of process and special venue provisions in private legal actions brought under Section 22 of the Act, the provision which permits private rights of action under the Act. This proposal is a customer protection provision which would allow, for example, a customer who is defrauded by an out-of-state boiler room operation to sue in his home state rather than being required to go to court in the state where the boiler room has its principal place of business. Specifically, the proposal would allow private damage actions to be filed in the district where the defendant is found, transacts business, or where the transaction constituting the violation occurred. Thus, this amendment would make it easier for commodity futures and options customers to bring private actions, placing them on an equal footing with customers who sue under Federal securities laws.

Our second legislative proposal is in the area of international law enforcement. As the process of internationalization of futures and financial markets continues, cooperative enforcement efforts with foreign futures authorities are becoming an increasingly important part of the Commission's enforcement responsibilities under the Act. Therefore, we are proposing a new Section 12(f) be added to the Act which would provide the Commission with explicit authority to conduct investigations on behalf of foreign futures authorities regarding violations of foreign laws, rules, or regulations relating to futures and options.

This legislative proposal would enhance our ability to cooperate with foreign futures authorities. It would allow the Commission, at its discretion, to conduct investigations in the U.S. at the request of foreign futures authorities even if no violation of U.S. law is implicated. The Securities and Exchange Commission (SEC) was granted similar investigative authority in the securities markets last year, and a number of our major foreign counterparts either already have this authority, or are currently seeking it.

Before conducting an investigation for a foreign authority, the Commission would be required to consider whether the foreign authority had agreed to provide similar assistance and whether granting assistance would be contrary to the public interest of the U.S. The amendment would also allow the Commission to provide confidential enforcement information to a broader range of foreign futures authorities, including foreign self-regulatory organizations (SROs).

Our third proposal amends Section 6(d) of the Act to eliminate the requirement that the Commission consider a wrongdoer's financial circumstances when assessing a civil monetary penalty. This amendment would give the Commission more flexibility in choosing appropriate monetary sanctions in the administrative law enforcement process.

The fourth proposal also amends Section 6(d) to suspend automatically the wrongdoer's registration with the Commission and to prohibit him from trading on all exchanges if he fails to pay the penalty when due. This proposal would create incentives for wrongdoers to pay penalties promptly. It is identical to the provision already in the Commodity Exchange Act mandating an automatic suspension of registration and a prohibition of trading if a party fails to pay a reparations judgment.

Our fifth proposal involves the registration of floor traders. Unlike floor brokers, who trade for customers as well as for themselves, floor traders trade only for their own accounts. Historically, floor traders have not been required to register under the Act because they do not handle customer trades or money and because exchange rules have established criteria governing their access to the floor. However, if floor traders collude with brokers in violation of the Act or of Commission regulations they should be subject to the same regulatory sanctions. By requiring floor traders to register, for example, this proposal would subject them to statutory disqualification and fitness requirements like other registrants.

We believe that the registration of floor traders would also assist in preventing persons with floor privileges who are sanctioned at one exchange from moving to other exchanges.

COMMODITY FUTURES IMPROVEMENTS ACT OF 1989

There are a number of legislative proposals in the Subcommittee bill that are not addressed in our legislative package. While the Commission has not had the opportunity to fully consider and develop a position on every aspect of the proposed bill, I would like to respond today with the Commission's preliminary assessment of the major provisions. Allow me to say at the outset, however, the Commission shares the overall goals of this bill -- to diminish the potential for trade practice abuse, strengthen the Commission's regulatory system, and maintain the integrity of futures and options markets, thereby increasing public confidence.

Audit Trail

An improved audit trail is a priority and has been a long-held Commission goal. The Commission moved aggressively toward this goal in 1986 by developing the one-minute trade timing requirement. More recently, the Commission asked each exchange to improve its system for reporting and using trade timing information to enhance its own trade practice surveillance program and requested a plan from each exchange for further improving their audit trail capabilities. Specifically, we requested that each exchange review the verifiability of trade timing data, accuracy levels, and its procedures for assuring accuracy of source records.

We are firmly committed to improve the audit trail in ways that are the most effective in detecting trade practice abuse. We must be realistic, however, about the capabilities of these systems once their potential has been achieved. Audit trail systems are records analysis systems and neither these nor any other kind of system can detect all types of trade practice violations.

Accordingly, we believe that a careful analysis is necessary before decreasing the trade timing standard to 30 seconds or less. Changing the timing standard from the current one minute trade execution requirement to 30 seconds or less, for example, may not provide sufficient improvements in overall audit trail capability to justify what could be a significant increase in cost, particularly to the smaller exchanges.

Other audit trail improvements may be more effective in detecting and preventing trade practice abuse. Such improvements could include collecting trading cards more frequently coupled with more frequent trade matching, granting compliance staff the authority to collect and copy trading cards on the floor, and limiting the entry of verbal orders by members on the floor. Similarly, we believe it may be a more effective use of exchange resources to move toward on-line order routing, execution and trade reporting systems which would provide many other benefits in addition to improved audit trails. With their increased emphasis on computerization, the exchanges are moving toward on-line systems and we should avoid requirements that could discourage this development and possibly force a detour back to mechanical systems.

We appreciate the Subcommittee's support of our efforts to achieve audit trail improvements. We believe that our existing authority is sufficient to accomplish this important objective and are actively pursuing that goal.

Dual Trading

We share the goals of the proposed legislation to rid the markets of abuses connected with the practice of dual trading. Indeed an original purpose of the enhanced audit trail was to obtain records to identify and deter trading abuses related to dual trading.

Earlier this year we began a study on dual trading to assess its role in fostering trading abuses and to determine whether any limitations on dual trading would adversely affect market liquidity. We expect our study to be completed in early October. Since our analysis is not yet complete, we believe that a statutory restriction based on specific volume levels would be premature.

We have concerns about the use of contract trading volume to trigger a dual trading prohibition. Using the average daily volume of 7,000 contracts as a trigger, as proposed under the bill, could have significantly different effects on different markets depending on such factors as the size and characteristics of each market's floor trading population. For example, the effects in the cattle futures pit, the gold pit, and the Eurodollar pit could all be quite different.

Accordingly, we believe that if specific restrictions on dual trading are to be set, they are more appropriately set by the Commission through its rulemaking authority. Through the rulemaking process we can apply a more flexible approach toward achieving the goal of eliminating dual trading abuses which we and the Subcommittee share. The Commission would be able to evaluate on a market-by-market basis the efficacy of dual trading taking into account the effects of any limitations on liquidity and the quality of audit trails. In this regard, we welcome the elements of flexibility provided in the bill in implementing the dual trading prohibition.

Undercover Authority

The Commission has a strong record of vigorous law enforcement. In the exercise of its own investigatory powers the Commission has traditionally cooperated with criminal and other law enforcement agencies, both state and federal. This has been most graphically demonstrated by the Commission's active assistance in the undercover operation in Chicago. We are pleased that the bill recognizes the importance of cooperative law enforcement with other agencies. We also strongly support the Subcommittee's intention to send a signal that these types of undercover activities may be undertaken at any time.

Broker Associations

We agree that it is important for the Commission to define and identify broker associations for the purposes of surveillance and compliance programs. However, we believe it is important to develop data concerning trading activities of broker associations based upon an industry-wide definition of such associations before attempting to determine what limits on intra-broker association trading might be appropriate. We are developing information on broker associations through interviews of industry participants and the study of current exchange rules and practices. Our study should be completed by the end of August.

We believe that a rulemaking is more appropriate than setting a statutory limit because effective monitoring of broker association activities could require restrictions to be tailored to particular markets.

Disqualification from Service on Disciplinary Committees and Governing Boards

The Commission supports the provision that would bar individual members with significant disciplinary records from service on disciplinary or governing panels of exchanges and futures associations for a fixed period of time. As stated in response to an inquiry from the Senate Committee on Agriculture, Nutrition and Forestry, we announced that we would promulgate proposed rules to address this concern by October 1989, even though some exchanges currently have rules prohibiting service on boards for certain periods of time.

We believe the bill gives us the flexibility to require SROs to establish what is a significant violation in a manner which will allow for sufficient diversity to reflect different exchanges' rules and trading practices, and in the case of the National Futures Association, the different industry components represented by the members.

Composition of Disciplinary Committees and Governing Boards

Currently, some exchanges have a two-tier disciplinary process in which one committee makes a determination whether charges should be issued and another committee hears the case regarding possible action based on those charges. Exchanges also require members of a committee to recuse themselves from a matter if they have a potential conflict of interest.

We are concerned that requiring a majority of committee members to be from a different sector of exchange membership than the person appearing before the committee may diminish the technical expertise of the group enough to slow down the process and to render a less effective and appropriate decision. Practically speaking, at some exchanges it also may be difficult, because of the limited size of a membership group, to achieve a balance between exchange membership groups. Because of the difference among exchanges in member composition, products traded, and size, we suggest that the requirements regarding committee composition and the stages in disciplinary process should be addressed in a flexible manner allowing for diversity across exchanges.

The Commodity Futures Trading Improvements Act of 1989 also would require that 20 percent of exchange governing boards be composed of outside members, and would require the Commission to provide guidelines defining who is an outside member. Most exchanges currently have rules which provide for some degree of board diversification and the Commission has announced it will monitor governing board composition within the rule enforcement review process. We favor having "public" members on such boards, and could develop a broader definition to include groups, such as market users, since they are knowledgeable about the commodities being traded as well as concerned with market integrity.

While a requirement for a minimum percentage of outside board members may add to the public confidence in the industry, the Commission believes a quota system does not always achieve the desired results. In a June 1985 report, the Commission found that the performance of public directors sometimes was limited by directors' absenteeism, failure to prepare sufficiently, and failure to provide expert assistance. These factors must also be recognized and considered before further restrictions concerning board membership become part of the statute or the Commission's rules.

Telemarketing Fraud

The Commodity Futures Improvements Act of 1989 would require the Commission to develop procedures to assure that non-hedging futures and options customers solicited by telephone for the first time cannot trade on newly opened accounts until three days after signing the account opening agreement. We believe this amendment is not necessary since under current Commission Regulations 1.55 and 33.7 no futures or commodity options transactions can occur legally until a first-time customer receives a certified written risk disclosure statement, including risk disclosure language mandated by Commission regulations, the customer acknowledges in writing that he has received and understood the disclosure statement, and the broker has in hand the signed statement, which he must retain.

Ethics

The Commission supports the idea that registrants be educated in the purpose and function of futures and options markets and in the rules and regulations which they must observe to legally trade in these markets. Such a program should include the fiduciary responsibilities of those in the industry who handle customer money. It is essential that all industry participants understand the significant sanctions they face if they abuse the markets and violate the law.

Registration Disqualification

The Commodity Futures Improvements Act of 1989 proposes several amendments to the registration disqualifications set forth in Section 8a of the Act. These proposals must be carefully evaluated for consistency with the statutory disqualification scheme Congress enacted in 1982. At that time Congress gave applicants and registrants clear notice of the primary standards the Commission would use to evaluate their fitness for initial or continued registration and granted the Commission flexible regulatory tools and authority to develop innovative procedures to streamline and simplify its registration process.

The current proposal raises concerns that it is not fully consistent with the logic that underlies the 1982 amendments. Certain provisions may create uncertainty among applicants, registrants and the general public as to the standards the Commission will apply in the registration context. For example, it appears that aspects of the proposals create overlaps between distinct categories of disqualification, which could increase uncertainty about the type of conduct covered by a disqualification. These overlaps also fail to reflect the basic distinction between the more serious types of disqualifications listed under Section 8a(2) and those listed under Section 8a(3).

We are also concerned about any amendment requiring the Commission to recognize the authority of other regulatory bodies to create or apply exceptions to the disqualifications listed in Section 8a. Such a provision will interfere with the Commission's ability to restrict such exceptions to those which protect the public interest. The proposal will make it more difficult to assure that the exceptions to the disqualifications recognized by the Commission are applied in a consistent and fair manner.

Period of Reauthorization

This is the fourth reauthorization of the Commodity Futures Trading Commission since the Commission was created in 1974. During these fifteen years the futures industry has enjoyed unprecedented growth. The Commission has developed into a mature and able regulator. We support your proposal to make the Commodity Futures Trading Commission a permanent agency. The misconception that the agency may somehow disappear is one that may erode public confidence and should be put to rest once and for all. Permanent authorization is consistent with regular and active Congressional oversight of the agency which the Commission has always supported.

I would like to submit for the record a brief outline (see Appendix) of our progress in dealing with 1986 reauthorization issues and amendments.

I would be pleased to answer any questions the Subcommittee may have.

Appendix

Summary Progress Report Regarding 1986 Reauthorization Issues and Amendments

* In January 1987, the Commission voted to end the options pilot program and to allow permanent trading of options on domestic farm product futures contracts and on physical commodities. This action completed the process begun in 1982 with the reintroduction of commodity options trading on U.S. exchanges.

* The Commission completed and published in February 1988 a survey of all traders holding positions in livestock futures and options as of March 13, 1987. The Commission found that, among those surveyed, no single trader or group of traders dominated the futures markets. In fact, the largest individual share on either side of any livestock futures markets was about six percent, and in both cases the largest individual share was held by a commercial livestock concern.

* In July 1987 the Commission clarified the hedging definition (Rule 1.3(z)) to permit institutional users of the futures markets to take certain positions that reduced overall balance-sheet risk but had previously appeared to fall outside of the traditional concept of hedging. In conjunction with the clarification of the hedging definition, the Commission published an interpretation of CFTC Rule 1.61 in September 1987 to permit exchanges to grant exemptions from certain exchange speculative

position limits in financial futures for certain risk management positions.

- In December 1987 the Commission amended Federal speculative position limits for some agricultural markets in response to futures industry concerns that previous levels were too restrictive.

- In addition, the Commission modified its aggregation policy for positions of commodity pools which have a common owner but which are independently controlled. The exemption would permit commodity pool operators to apply to the Commission for a higher speculative position limit on a case-by-case basis.

- Early in fiscal year 1988, the General Accounting Office (GAO) completed, with the Commission's cooperation, its mandated study of the cattle futures market. The GAO report concluded: "The preponderance of the information suggests... these markets are working fairly well and are serving the traditional economic purpose of enhancing price discovery and facilitating risk shifting.... Exchange and CFTC regulation of the cattle futures markets appears to be working well. Manipulation of the cattle futures markets has never been proved, and other violations have been detected at a lesser rate than in other commodity futures markets."

- In February 1988, the Commission, with the assistance of the National Futures Association, published and transmitted to Congress its Leverage Survey Report. In November 1988, the Commission forwarded to Congress its final report discussing the amount of interest in the offer and sale of leverage contracts and proposing changes to Commission rules to permit additional commercial interests to enter the leverage business.

TESTIMONY OF JOHN M. DAMGARD
PRESIDENT
FUTURES INDUSTRY ASSOCIATION

BEFORE THE HOUSE AGRICULTURE SUBCOMMITTEE ON CONSERVATION, CREDIT, AND RURAL DEVELOPMENT
RE: H.R. 2869

Mr. Chairman and members of the Subcommittee, my name is John Damgard, and I am here today in my capacity as president of the Futures Industry Association (FIA). Thank you for the opportunity to appear before you today on behalf of the members of the FIA.

The FIA is the national trade association of the commodity futures and options trading industry. Our regular membership is comprised of more than 100 of the largest futures brokerage firms, known as "futures commission merchants" or "FCMs." They handle more than 80 percent of the transactions on the U.S. futures exchanges. Our associate and international members, which number nearly 200, are a more diverse group. They include all U.S. and many foreign exchanges and clearinghouses, law firms, accounting firms, and users of the markets, such as commercial and investment banks, and pension, insurance and mutual fund managers. Although our membership includes all facets of the futures industry, the FIA has its roots in the brokerage community, which links the futures markets with its public participants. At the FIA, our primary concern is to protect the interests of those who use and benefit from our markets.

Today, the FIA is pleased to offer its support of H.R. 2869. Congressmen Glenn English, Tom Coleman, and Timothy Penny have introduced a bill that the FCM community believes can be the basis for reforms that will usher futures trading into the 21st century. We share the view embodied in the legislation that an improved audit trail is the key to these reforms. An audit trail that can be verified and that accurately reconstructs the sequence of trading in a timely manner has been the goal of the U.S. futures community for the entire 14 years of the CFTC's existence.

Audit Trail and Dual Trading

In 1974, the House Committee drafted amendments to the Commodity Exchange Act which established a system of self-regulation in the industry, accompanied by active oversight from the newly-created CFTC. The premise of the Commodity Exchange Act is that the exchanges will police themselves and that the CFTC will review the efficacy of these efforts. It has long been the view of the FIA that without a verifiable audit trail, which accurately accounts for every trade, the exchanges, the CFTC, and indeed Congress itself lack the tools necessary to assure the public that the markets are free from abuse. We believe that until a verifiable audit trail is in place in every exchange, the futures industry, the CFTC and Congress will be vulnerable to public skepticism -- no matter how ill-founded -- about the integrity of the system.

The exchanges have made tremendous advances in their audit trail systems during the last few years. That progress can be seen both in the CFTC rule enforcement reviews -- highlighted in a recent report by your Subcommittee's inquiry team -- as well as in the sustained growth in the volume of futures trading. But there is more work to do, and sometimes the last mile is the most difficult to traverse.

The bill under consideration today requires that the exchanges refine their audit trails within a stated time frame. Namely:

> -- after the first year the legislation has been in effect, the exchanges must provide the verifiable time of execution for every futures or options trade in increments no greater than a minute.
>
> -- no later than three years from the effective date of the legislation, the exchanges must refine their audit trails to increments of no more than 30 seconds.

The proposed bill also requires the CFTC to furnish Congress with a report after five years as to whether these trading records provide effective enforcement of the Act and whether improved technologies could better time the trades.

The FIA strongly supports these amendments to Section 4 (g)(2) of the Act. We believe, however, that analyzing the audit trail's efficacy and exploring new technologies to achieve optimal enforcement of the CEA are paramount. This work should be ongoing, and Congress should request yearly reports on its progress.

The Subcommittee has indicated its belief that existing audit trails may not detect some trading abuses which accompany dual trading. The Subcommittee therefore proposes limiting a broker's ability to engage in dual trading, except in special situations, where an average volume of over 7,000 contracts are traded daily. The only exclusion is a case where the exchange's audit trail can detect "any and all instances of trading violations that the CFTC determines to be attributable to dual trading and where the audit trail is fully verifiable."

A recent Chicago Mercantile Exchange Special Committee Report addressed the public confidence issue that can accompany dual trading. As the report said: "...it has become painfully evident that the public image of futures markets and their members has been adversely impacted by the widely-held belief that dual trading in futures leads to customer abuses." The CME's Special Committee suggested that the exchanges ban dual trading in "mature, liquid" markets. This would affect about 80 percent of all transaction on the CME.

Thus, both Congress and the Special Committee recognized that while some abuses may accompany dual trading, banning it altogether might adversely affect the less liquid markets. The FIA has supported this view with the important caveat that, whenever dual trading is permitted, there should be adequate safeguards in place to assure the integrity of the market. An audit trail system that detects abuses and an exchange that will take action against those who abuse the system provide such safeguards.

The FIA, therefore, believes that H.R. 2869 correctly links dual trading to a more precise audit trail. It is difficult, however, for Congress to legislate whether certain markets are sufficiently liquid or whether they require the liquidity afforded by dual trading. We would prefer that the Congress direct the CFTC to review the efficacy of such a liquidity test. In particular, we believe there may be other considerations -- quite apart from how many contracts are traded -- in determining what is an active, liquid market. Moreover, since the CFTC reviews and monitors the performance of audit trail systems, the CFTC is in a position to assess the system's ability to detect and prosecute trading abuses.

The CFTC currently is addressing dual trading and has promised to report on economic and other aspects of the issue by September of this year. We respectfully suggest that it is in the best interest of customers and the industry alike to take a close look at the CFTC's study and others underway before acting definitively on dual trading. If after reviewing the Commission's recommendations, the Committee finds that the interest of the public customer has not been adequately addressed, the Committee could consider additional legislative changes.

Broker Associations

The FIA has previously supported the registration of broker groups. We have recommended that each exchange review whether limitations on trading with other association members or other limitations should be implemented, based on experience with such broker groups on that exchange. We are aware that the Commission has begun a review of issues involving broker associations and the different exchange rules and policies involving them.

The CFTC's recommendations on broker associations are due in August. We recommend that the Subcommittee take into consideration the CFTC's report before finalizing legislative proposals in this area.

Telemarketing Fraud

The Subcommittee's inquiry team has focused on the solicitation by a few firms of persons who, unaware of the risks of trading futures and options, are enticed to become customers through high-pressure telephone solicitations. In response, the proposed legislation includes a provision which requires the CFTC to adopt new regulations to prohibit any person who has solicited a customer by telephone from entering any orders for three days after the customer signs any contract and the prescribed risk disclosure statement opening the account. This three day "cooling off period" would not apply to other than the first account opened by a customer with the same firm, or for accounts opened solely to "hedge."

The FIA understands the Subcommittee's concern with high pressure sales. Individuals and firms who use such tactics to defraud customers do not belong in the industry, and we support all efforts to remove them. We are concerned, however, that the language the Subcommittee is proposing will result more in frustrating the legitimate users of futures and options than in eliminating the bad apples. The regulators will have difficulty in defining what is a first time sales solicitation, and the firms will have a next to impossible time supervising for compliance with the rule. Large firms have told us they would be forced to hold all customer trades for three days because of the supervisory problems related to compliance.

There is a considerable body of Commission and judicial precedents establishing that the Commodity Exchange Act and CFTC regulations can be used successfully to prosecute telemarketing fraud. Already there are in place broad federal and self-regulatory prohibitions against high pressure tactics and other fraudulent practices in the offer and sale of futures and options. In addition, customers have successfully brought cases to obtain money damages under Section 14 of the Commodity Exchange Act, the reparations section, and have filed arbitration claims at the National Futures Association against salesmen and firms who have defrauded them using high pressure sales tactics. With the Subcommittee's permission, we are submitting for the record a copy of a letter from the CFTC to the Chairman of the House Energy and Commerce Committee which annotates cases the CFTC's enforcement division has successfully brought in both court and the administrative area against registrants involved in telemarketing fraud. The letter also lists a series of CFTC reparations cases involving such practices.

Unlike others in the financial services area, futures professionals already provide specific risk disclosure statements to all futures and options customers, and these disclosures must be acknowledged and returned before a firm may take a customer's trade. In most cases this procedure alone would provide customers with a cooling off period. Futures professional must comply with NFA rules which regulate the content of all communications between NFA members and the public. These rules specifically prohibit fraud, deceit and high pressure sales practices.

It was noted during the recent Subcommittee hearings that the NFA program to answer ads and pose as potential customers is an effective way to discover high pressure tactics and take action. This system should be enlarged and adopted by other industry self-regulatory organizations that have a responsibility in this area, and we believe it will.

The FIA would like to continue to work with the Subcommittee to help it fashion a proposal that is appropriately directed at those persons and firms on the periphery of the industry who are using unlawful sales tactics.

Undercover Operations

The Subcommittee's proposal will permit the CFTC to request help from and to cooperate with other agencies in conducting investigations, including undercover operations. The Subcommittee therefore is recognizing the difficulty of detecting all illegal behavior through normal investigatory procedures. The FIA supports the legal application of such undercover procedures.

SRO Governing Boards and Disciplinary Committees

We place a high priority on adopting rules which would require that persons of high integrity serve on the boards and disciplinary committees of the exchanges and the NFA. In most cases, we believe persons who are likely to be elected to the boards of the exchanges and NFA are respected in the industry for their business ethics and reflect well on the industry. Persons serving in the leadership of self regulatory organizations are there to protect the public participants in the markets, and their decisions should not be open to question because of regulatory problems in their pasts.

The FIA also supports the requirement that disciplinary committees be composed of persons who are of a "different trading status" from the respondent. This requirement appears to be reasonable, with the additional proviso that an exchange be able to put non-exchange members on such panels in special cases.

Whether governing boards should be comprised of at least 20 percent public members has already been decided by several exchanges which have opened their boards to more outside members. Our only caveat is that public members should be expected to have a working knowledge of futures markets. The FIA also has been concerned about increasing the actual representation of non-floor interests on exchange boards. To that end, we have asked the Congress and the CFTC to encourage exchanges to have broad representation on their boards.

Enhanced Registration Requirements

The FIA also strongly supports the Subcommittee's proposed changes to the statutory disqualifications requirements. Stringent requirements for the initial licensing of firms and individuals can, among other things, have a salutary effect on customer protection; it is in everyone's best interest to keep persons with questionable backgrounds from entering the industry.

Registration of Floor Traders

The proposal to register floor traders so that they receive the same kind of FBI check and background review as other industry registrants also appears to be in the public interest, and we fully support its enactment.

Ethics

Recently, there has been increased interest in ethics training in financial markets. Several universities, in some cases with generous support from industry leaders, have developed ethics training and research programs. The FIA recognizes the challenge of providing effective training in this area. We fully support the effort to increase industry registrants' knowledge of and sensitivity to ethical considerations involved in soliciting and handling customers' accounts and trading in futures markets, whether for customers' or proprietary accounts.

CFTC Reauthorization

Whether the "sunset" of the CFTC is a real or perceived problem, the FIA believes Congress should take every step necessary to give the Commission permanent status. We support the appropriations figures for 1990 and 1991 and commend the Subcommittee's actions to eliminate any uncertainties in the Commission's future. The CFTC should have permanent status, similar to the Securities and Exchange Commission, because it will provide for stability and continuity of regulatory leadership.

CFTC Proposals

The CFTC has recommended four provisions that would:

-- Authorize nationwide service of process in private actions filed in Federal court based on violations of the Commodity Exchange Act;

-- Permit the CFTC to engage in cooperative enforcement efforts with foreign futures authorities;

-- Delete the requirement that the CFTC consider net worth and ability to continue in business in determining the amount of civil monetary penalties; and,

-- Provide for automatic suspension of registration and a trading prohibition upon failure to pay a civil monetary penalty.

The FIA can support the thrust of all four amendments.

However, the specific language of all of H.R. 2869 warrants closer review than was possible during the time we were given to prepare this testimony. Therefore, we ask the Subcommittee's permission to submit additional comments and suggestions for the record.

COMMODITY FUTURES TRADING COMMISSION
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OFFICE OF
THE CHAIRMAN

May 23, 1989

The Honorable John D. Dingell
Chairman, Committee on Energy and Commerce
U.S. House of Representatives
2125 Rayburn House Office Building
Washington, D.C. 20515

Dear Mr. Chairman:

Thank you for your letter of April 28, 1989, advising us that the Subcommittee on Transportation and Hazardous Materials has favorably reported H.R.1354. You also noted that several members expressed support for amendments to the bill that would avoid needless overlapping regulations. The Commission shares those views. In our letter to you of April 24, 1989, we proposed an amendment to exempt from the coverage of the bill activities already regulated by the Commission.

However, please be assured that we also share your concern over the problem of "boiler room" investment scams. In this regard, we wish to emphasize at the outset that the type of amendment we support would not exempt such unscrupulous operations from the reach of H.R. 1354. Our proposal is not a "blanket exemption" for all commodity-related instruments. As stated in the explanation accompanying our April 24 letter, only those contracts and transactions within the Commission's exclusive jurisdiction would be exempted.

For example, persons who sell unlawful off-exchange commodity futures contracts or who do not obtain a license as required by the Commodity Exchange Act ("Act") do not operate within the Commission's exclusive jurisdiction. In such cases, the Act explicitly provides that any other federal or state statute, including one like H.R. 1354, may be invoked against persons engaged in this type of unlawful conduct.1/ We therefore believe

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1/ See Section 12(e) of the Act, the so-called "open season" provision. This section was enacted in 1983 at the request of
(Footnote Continued)

that an amendment to H.R. 1354 like that we have proposed is fully consistent with the bill's purposes to combat telemarketing fraud and will at the same time avoid unnecessary regulatory duplication and conflict for those who do operate within the Act's framework.

Under that framework there are already in place broad federal and self-regulatory prohibitions against high pressure and other fraudulent practices in the offer and sale of instruments regulated by the Commission. Specifically, the Act and the Commission's rules contain several broad antifraud provisions: Section 4b of the Act (futures contracts); Section 4*o* (commodity trading advice and pool operations); Rule 33.10 (exchange-traded options); Rule 32.9 (trade and dealer options); Rule 30.09 (foreign futures and options); and Rule 31.3 (precious metals leverage transactions).

With regard to law enforcement, there is a considerable body of Commission and judicial precedent establishing that these provisions cover fraud in the telemarketing of instruments and services regulated under the Act. The Commission's Enforcement Division has successfully brought both court and administrative cases against registrants involved in telemarketing fraud.[2] In addition, under Section 14 of the Act, customers themselves may

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(Footnote Continued)
the Commission and was relied upon by the North American Securities Administrators Association, Inc. in drafting the Model State Commodity Code in 1985. The Code outlaws various forms of fraud and commodity-related transactions but exempts from its coverage transactions within the Commission's exclusive jurisdiction. Commission staff assisted NASAA in its drafting of the Code and Commissioner Fowler C. West has appeared before several state legislatures urging its passage. We understand that versions of the Model Code have now been enacted in nine states and are awaiting the Governor's signature in two others.

[2] *See*, *e.g.*, *CFTC v. Bernth et al*., Civ. 88-8130 (S.D. Fla. 1980) (Section 4b); *CFTC v. Chilmark Commodities Corp*., Civ. 88-6058 (S.D. Fla. 1988) (Rule 33.10); *CFTC v. Commodity Fluctuations Systems, Inc*., 83 Civ. 5909 (S.D.N.Y. 1983) (Section 4*o*); *CFTC v. First National Monetary Corporation*, 32 C 7707 (N.D. Ill. 1982) (Section 4*o*); *CFTC v. Multi-State Advisory Corp*., 81 Civ. 2953 (D.N.J. 1981); *In the Matter of Multi-State Advisory Corp*., CFTC Dkt. No. 82-4 (Section 4*o*); *CFTC v. Multi-National Holding Corp*., Civ. 82-2173 (S.D.N.Y. 1982); *In the Matter of Multi-National Holding Corp*., CFTC Dkt. No. 83-5 (Section 4*o*); and *CFTC v. Trending Cycles for Commodities, Inc*., Civ. No. 80-315 (S.D. Fla. 1980) (Section 4*o*).

bring reparations cases before the Commission to obtain money damages for violations of any of these provisions committed by registered commodity professionals. Many of these reparations cases have involved telemarketing fraud.[3/] Similarly, Section 22 of the Act provides an express right of action in federal district court for customers to seek money damages for any violation of the Act, including the antifraud provisions. Further, Section 6d of the Act authorizes state officials to bring cases in federal district court to enjoin fraudulent conduct or seek money damages on behalf of their defrauded citizens. Section 6d also provides that state officials may proceed in state court against most classes of Commission registrants, specifically for violations of the antifraud provisions of the Act or Commission Rules.[4/]

Industry rules and procedures also cover telemarketing fraud. The National Futures Association and all futures exchanges have rules which generally prohibit their respective members from making fraudulent, deceitful or high-pressure solicitations of customers to trade futures or option contracts.[5/] The Commission

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[3/] See, Hannay v. First Commodity Corporation of Boston, [Current Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,936 at 34,279 (CFTC September 21, 1987)(Section 4b); Toub v. Apache Trading Corp., [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,975 at 31,854 (CFTC March 6, 1986)(Section 4b); Piskur v. International Precious Metals Corp., [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,493 at 30,184 (CFTC January 2, 1985)(Rule 31.3); Reed v. Sage Group, Inc., [Current Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,943 at 34,296 (CFTC October 14, 1987)(Rule 33.10); Tavel v. International Trading Group, Ltd., [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,722 at 33,867 (CFTC July 9, 1987), affirming Tavel v. International Trading Group, Inc., [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,199 at 32,524 (CFTC August 12, 1986)(Rule 32.9).

[4/] State officials may not proceed in state court against registered floor brokers or futures associations.

[5/] See, National Futures Association, Compliance Rule 2-29; Amex Commodities Corporation, Rule 701; Chicago Board of Trade, Rule 506.00; Chicago Mercantile Exchange, Rules 432 and 433; Chicago Rice and Cotton Exchange, Rule 300.01; Coffee, Sugar & Cocoa Exchange, Inc., Rule 1.13; Commodity Exchange, Inc., Rules 3.04 and 3.05; Kansas City Board of Trade, Rule 1000.00; MidAmerica Commodity Exchange, Rule 701; Minneapolis Grain Exchange, Rules 775.00, and 1700.00; New York Cotton Exchange, Rule 9.01; New (Footnote Continued) continually assesses and recommends improvements to the effectiveness of these self-regulatory standards through its rule enforcement reviews of the sales practice programs which are conducted at each exchange and the NFA on a biennial schedule. Finally, the Act and Commission Rules require the exchanges and registered futures associations to provide voluntary arbitration under which customers can seek damages for fraudulent conduct and other violations committed by exchange or association members. Sections 5a(11) and 17(b)(10) of the Act; 17 CFR Part 180.

We believe the foregoing demonstrates that the Act already provides a comprehensive regulatory scheme to prohibit and redress telemarketing fraud that may occur in the solicitation of Commission-regulated instruments. We trust that you will find this information responsive to the concerns raised in your letter as the Committee continues its work on H.R.1354. We appreciate this opportunity to comment on this important legislation and hope that you and other members of the Committee will be able to support an amendment of the type we have suggested. Please call me if you have any questions about the views we have expressed.

Sincerely,

Wendy Gramm

Wendy L. Gramm
Chairman

cc: Hon. Thomas Luken
Hon. Glenn English

(Footnote Continued)
York Futures Exchange, Inc., Rules 351, 357 and 358; New York Mercantile Exchange, Rule 8.53; and Philadelphia Board of Trade, Rule 259.

National Grain and Feed Association

Statement of the National Grain and Feed Association

by Frank Beurskens

before the

Subcommittee on Conservation, Credit and Rural Development
U.S. House of Representatives

July 18, 1989

Mr. Chairman and Members of the Subcommittee, my name is Frank Beurskens, and I am president of Advance Trading Inc., in Bloomington, Ill. My company works with elevator companies and directly with farmers and other small commercial hedgers on grain pricing and risk management. I am presenting this statement today on behalf of the National Grain and Feed Association (NGFA). My company is an active member of NGFA and I serve on the Commodity Exchange Committee of the Association.

The membership of the National Grain and Feed Association encompasses more than 1,300 companies representing some 5,000 facilities that handle and merchandise about two-thirds of all U.S. grain and oilseeds. Our membership is comprised of every segment of the grain and feed industries -- country elevators, terminals, merchandisers, exporters, feed manufacturers and primary food processors.

Members of NGFA rely heavily upon the futures markets to hedge purchases and sales of grain and/or grain products. The futures markets of today that play a critical role in agricultural and financial markets, had their beginnings in Chicago more than 100 years ago. It was the grain trade that pioneered these efforts and the major grains were the commodities first traded on these exchanges. In the ensuing decades futures trading has expanded to other commodity sectors where futures have proven themselves repeatedly to be efficient and viable marketing and risk management mechanisms for a wide array of commercial business interests.

The U. S. grain industry is proud of the role it played in the development of commodity futures markets. It is pleased with the expansion that has transpired in the futures industry. The NGFA believes it has been a constructive, positive force during this development and growth process. It is a matter of record that this Association has been a responsible cooperative counselor to the Congress and other branches of government, and has aided government as it has considered legislation and regulatory proposals pertaining to futures markets.

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Continuation of viable futures markets is critical to a competitive and efficient marketplace for agriculture. The price discovery mechanism provided by the futures markets benefit the entire national economy as it ensures fair prices are offered to both producers and consumers alike. Just as important to the smooth functioning of a competitive marketplace is the risk management mechanism provided by futures and options markets. Without the opportunity to shift risks via these markets, commercial interests would be unable or unwilling to offer many of the marketing services available today. Futures markets provide the efficiency and risk transferral mechanisms necessary to offer marketing services at the lowest cost possible, which benefits both the producer and ultimate consumer of agricultural commodities. Futures markets are truly the cornerstone of an efficient marketplace.

This year, 1989, marks the 15th anniversary of the Commodity Futures Trading Commission as an independent body regulating futures trading. While the CFTC has overall regulatory authority of futures trading and is responsible to Congress, the exchanges themselves and self-regulatory organizations also assist in market regulation. We continue to believe that all futures markets should be regulated by an independent regulatory body. Over the years, CFTC has proven its capability to regulate effectively while allowing markets to perform their intended economic function. For this reason, we support the continued reauthorization of the CFTC. We also support an open-ended reauthorization, with no specific sunsetting of the agency. The budgeting and appropriations processes will continue to provide periodic oversight by the Congress and, if unusual circumstances justify, Congress can always use its investigatory powers to review problem areas at its discretion. CFTC, in our view, has earned the right to become a permanent federal agency, and absent the need to embark on the reauthorization process every three or four years, should be able to devote more of its resources to actual market surveillance and enforcement activities for which it is intended.

While not under active consideration, the issue of margin-setting authority being vested in one or more government agencies remains a primary concern for our industry. It is our firm belief that margins on futures contracts should continue to come under the sole purview of the individual futures exchanges.

There seems to be continuing confusion about futures market margins that cause some to believe that there is similarity between margins on securities and margins on futures. The purpose of margins in futures markets is to ensure the financial integrity of all futures buyers and sellers. The purpose of margins in securities markets is to serve as a down payment on a credit transaction. The purpose of securities markets is to transfer title from one security owner to another. The function of futures markets is not to transfer title, but rather to transfer price risk. Thus, the futures margin acts much as a performance bond, and depending on price volatility and risk in any given market, is subject to change.

We do not believe any government agency, no matter how enlightened or well-intentioned, possesses the capability to manage the margin responsibilities for futures markets. We do not believe any government agency could be sufficiently responsive to changes in margin levels that frequently must be effected in an environment of fast-breaking changes that necessitate rapid, immediately implemented decisions on margin levels. In our judgment, only the individual exchanges have the capability to deal with the logistical realities of margin-setting responsibilities.

Notwithstanding the current investigations of some exchange activity, from our perspective as commercial hedgers, we believe that commodity markets are generally functioning very efficiently under the current regulatory structure. We believe that an over-reaction in the name of regulation could well do considerable damage to efficiently running markets. At the same time adequate self-regulation by exchanges, self-regulatory organizations and the CFTC must be taken very seriously if the self-regulatory structure is to be maintained with confidence. Thus, while the system is performing reasonably well, everyone with interest in the long-term viability of futures markets, should welcome the opportunity to consider means of improving market regulation and surveillance to ensure the highest degree of integrity in trading.

A principal issue of these hearings and of H.R. 2869 is how to best regulate markets to minimize potential abuse of dual trading practices. First, it is vital that Congress understand that the practice of dual trading is very necessary in many markets to maintain liquidity. Adequate liquidity is important to hedgers as the cost of placing hedges can go up tremendously in thin, lightly-traded markets. Thus, dual trading is not bad per se; in fact it contributes strongly to the efficiency of futures markets today. Clearly, however, the use of dual trading can be abused, and close surveillance by CFTC and exchanges is necessary.

H.R. 2869 would ban dual trading in markets whose daily volume exceeds 7,000 contracts. However, there would be a number of exceptions to this rule. CFTC could choose to adjust the 7,000 contract level if the dual trading ban created increased volatility or wider bid-ask spreads. Also, a broker could dual trade if authorized by his customer. Finally, the bill would allow a lifting of the dual trading ban for exchanges fully implementing trade tracking systems capable of reconstructing fully verifiable audit trails that detect all potential trading violations.

While this section of the bill is well-intentioned, and correctly links potential for dual trading abuse with the need for improved audit trails, we believe the provision would create a number of problems. First, it is very difficult to determine a single volume, whether 7,000 contracts traded daily, or some other figure that defines a liquid market, that does not need the flexibility of dual trading to encourage volume. It is reasonable to assume that any market that loses the dual trading function will suffer some volume loss, and therefore some degree of loss in trading efficiency. Secondly, allowing customers to give written authorization to brokers to override the dual trading ban would lead to the question of just who is the customer. Is the customer the futures commissioner merchant sending orders to the broker on behalf of clients? Or would every public customer have to authorize a particular floor broker to be able to dual trade? Third, the accuracy of the audit trail is paramount to improving exchange surveillance and should be pursued vigorously, but technological feasibility and the cost of 100 percent accuracy have to be reviewed.

We believe that dual trading is an important part of marketplace efficiency and Congress should endeavor to avoid an outright ban of dual trading in any futures markets, if at all possible. Rather than a ban, we would support an approach in which Congress legislated a specific directive to CFTC on audit trail objectives that should be pursued by exchanges, and require interim reports on progress toward those goals. We would also support requirements on tightening surveillance activities during heavy trading periods when abuses are more likely to occur. Until audit trails are improved to the point that all instances of dual-trading violations can be detected with a high degree of certainty, more stringent surveillance is necessary to reassure the trading public that dual-trading privileges are not being abused. At the very extreme, if increased surveillance does not prove adequate, dual trading could be curbed during brief opening and closing periods of the trading day, when volumes tend to be fairly heavy with wide variability in prices.

While we agree with the intentions of Congress to guard against abuse of dual trading, we believe it is very difficult to set such specific guidelines applicable to all markets, without creating some substantial adjustment difficulties in certain markets. We would support an approach giving CFTC specific legislative objectives concerning audit trails, and authorizing the CFTC to write specific rules with stringent penalties for noncompliance. We believe this approach would provide adequate public protection and preserve the market liquidity necessary for market efficiency and viability.

Other items addressed by H.R. 2869 include a specific restriction on trading between members of broker associations. The linkages between possible restrictions on dual trading being avoided by trading through groups are evident. However, it is not clear to NGFA that improved audit trail systems would not provide equivalent protection. Artificial restrictions on trading volumes place an additional constraint on efficient marketplace performance. Thus, if there is a means of equivalent protection through better audit trails or some other mechanism that does not add another market restriction, it would be more desirable.

We support the provisions in H.R. 2869 that would prohibit the participation on governing boards and disciplinary panels by those members found guilty of major rule infractions. Our Association also welcomes the expansion of representation of non-floor membership on governing boards of exchanges. But we think such new representatives have to be carefully selected to ensure participation by knowledgeable, interested parties that will give sound independent input to the exchanges.

While offering no specific position on the provisions of H.R. 2869 that attempt to reduce telemarketing fraud and encourage evenhanded treatment of all violators by exchange disciplinary committees, we fully support the intent of these provisions to encourage a high level of ethics and integrity in the function of futures markets.

We appreciate the opportunity to present our views on CFTC reauthorization, and pledge our support and cooperation throughout the legislative process. I would be happy to respond to any questions the Subcommittee may have.

KANSAS CITY
BOARD OF TRADE

TESTIMONY OF
THE KANSAS CITY BOARD OF TRADE

on the proposed

Commodity Futures Improvements Act of 1989

to be presented before

THE U.S. HOUSE OF REPRESENTATIVES
SUBCOMMITTEE ON CONSERVATION, CREDIT, AND RURAL DEVELOPMENT

by
Michael Braude
President

July 18, 1989

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Chairman English and distinguished members of the Committee:

Roger Stover, chairman of the exchange, and I very much appreciate the invitation to appear here today to discuss the Kansas City Board of Trade's views on your proposal to reauthorize the Commodity Futures Trading Commission.

I am Michael Braude, president and chief executive officer of the exchange.

Mr. Chairman, a member of your staff visited the Kansas City Board of Trade on two occasions during the course of your committee's work, and I want you to know that we appreciate the spirit of cooperation that characterized those visits. We felt the intent of his visit truly was to learn as much as possible about our operations and our audit trail in particular.

Let me preface these remarks with the statement that since I joined the exchange five and a half years ago my experience has been that the Commodity Futures Trading Commission has done an exemplary job of governing the commodities industry through a very challenging period in the industry's development: a time of phenomenal growth in trading volume, in numbers of products traded and in the diversity of instruments available for trading. The recent government investigation looming as it is over these proceedings, I feel it important not to lose sight of the mammoth job that confronts the CFTC daily and the success with which they've accomplished the task thus far.

Now, let me specificially address the provisions of the reauthorization bill as put forth by your committee.

Permanent Reauthorization

The Kansas City Board of Trade supports unequivocally the proposal to make the CFTC a permanent government agency. The commodities industry has matured over the past 10 years into a key player in the international risk management arena and the CFTC has proven itself a capable and tough regulator through that significant period.

The process of reauthorization dictated by the current structure causes an unreasonable drain on CFTC, industry and Congressional resources in the continual effort to rejustify the agency's existence. The current structure also hinders the effectiveness of the Commission by making it a political pawn precisely at those crisis moments when full Commission resources are needed to deal with the situation at hand.

To give the Commission permanent status sends the clear message to other government agencies and to the financial markets that the agency has the full support of Congress. The next decade promises a new set of challenges for the commodities industry both from within our borders and outside them, and permanent reauthorization creates a firm foundation from which the Commission can face those challenges.

Dual Trading

Since the news broke earlier this year of the investigations into the Chicago commodity markets, dual trading has become the battering ram of those who would like to see the industry constricted. The Kansas City Board of Trade would like to use this opportunity to put forth that dual trading, in and of itself, is not a problem; dual trading is an accepted, legitimate and necessary component of futures trading, especially at smaller exchanges.

The key to dual trading lies in whether the exchange in question has the appropriate systems in place to detect dual trading abuses. Those procedures may vary by exchange, depending on such variables as the number of traders in a particular pit, trading volume in that pit and the sophistication of the exchange's computerized surveillance system. We at the Kansas City Board of Trade are continually upgrading the effectiveness of our audit trail surveillance system, as most likely are the other exchanges, because we recognize the need to innovate to keep up with the ever-changing markets.

Dual trading has been allowed these many years in the trading pits because it yields a significant economic advantage. By improving the liquidity of the pit, dual trading helps to assure as narrow a bid-ask price spread as possible, with benefits accruing to all participants in that market. A natural consequence of restricting dual trading is to reduce the efficiency of the pit by constricting the population of brokers available to fill orders. This reduces pricing, as well as execution, efficiency. If not handled with care, restrictions on dual trading can intensify the very problems this committee is trying to solve and possibly cause a few more.

Current CFTC regulations clearly detail the responsibility of exchanges to survey, examine and investigate their markets to protect against trading abuses, including those that may result from dual trading. It is our opinion that any exchange that can demonstrate itself capable of fulfilling that duty should be allowed to continue to dual trade, no matter how large daily volume in a particular pit may be. Conversely, any exchange that cannot prove itself capable should not be allowed to dual trade, no matter how low its daily volume.

Audit Trails

Your committee recognizes that a key to effective monitoring of trading activity, including dual trading, is through an effective audit trail. We agree with you. The Kansas City Board of Trade was the first exchange to require what we call "timing to the minute," and we practiced such in our pits long before we were required to do so. Our system has been recognized for its effectiveness since its implementation.

Nonetheless, people who have not been directly involved in the development of such timing systems should be fully aware of the difficult nature of the work involved. While the Kansas City Board of Trade is willing to work toward the committee's proposed one-year requirement of a stricter one-minute standard and the three-year requirement of a 30-second rule, we urge the committee to allow the CFTC reasonable flexibility in determining how and when the standards have been met. The challenge of the task will not be clear until work has begun.

Broker Associations

Our opinion on broker associations is similar to our opinion on dual trading. Broker associations in and of themselves are not a problem if an exchange has the mechanisms in place to detect violations of trading rules. In fact, formal and informal broker associations may help the markets by improving trading accuracy and efficiency.

Restricting the type and degree of trading between members of a broker association is second best to having the procedures in place to detect any abuses as they occur. The placement of restrictions also assumes that broker associations are a formal business entity, when in fact the majority of such associations are quite informal and can very easily be camouflaged or disbanded to circumvent restrictive rules. To be effective, any proposal dealing with broker associations should, at a minimum, define what a broker association is and require that groups meeting that description be registered as such with the appropriate exchange.

Governing Boards

Our exchange has no problem with your proposals to make members found guilty of certain exchange violations ineligible to serve on governing boards and certain exchange committees or disciplinary panels for a set period of time. Likewise, the exchange has no problem with having 20 percent of its board members from outside the exchange.

Other Issues

Our exchange also can accept the provisions as put forth in the proposal to:

--Require the establishment of disciplinary committees at each exchange that are large enough to include a majority in a category other than that of a person being tried.

--Require the CFTC to put into place stricter procedures to regulate telephone solicitation of commodity accounts.

--Require the CFTC to establish standards to register floor traders, and

--Require new registrants to attend ethics training.

Summary

The Kansas City Board of Trade applauds the committee's recommendation to make the CFTC a permanent agency, thereby setting the regulatory tone needed to carry the futures industry into the 1990s.

The exchange also respects the committee's attempts to protect the public good by trying to legislate against potential trading abuses, specifically from dual trading and broker associations. However, the Kansas City Board of Trade feels that those issues, as well as the general good of the investing public, can best be served by focusing each exchange's efforts on developing a comprehensive audit mechanism to seek out rule violators. Only those exchanges not able to meet a reasonable standard should be made to confront the consequences.

The U.S. commodities industry has established itself successfully in the international financial marketplace. As in any growth industry, however, continuing success will depend on how the U.S. industry meets the challenges that lie ahead, both at home and abroad. The committee's proposal modified to include our suggestions provides an acceptable framework on which to base those efforts. We commend the committee for its work in drafting this legislation.

Thank you for the opportunity to appear here today.

New York Mercantile Exchange

Statement of Z. Lou Guttman
Chairman of the Board of Directors
New York Mercantile Exchange

Before the
United States House of Representatives
Committee on Agriculture
Subcommittee on Conservation, Credit and Rural Development

Mr. Chairman and Members of the Committee and Subcommittee. My name is Lou Guttman and I am Chairman of the Board of Directors of the New York Mercantile Exchange. On behalf of the Exchange, I want to thank you for the opportunity to appear before this Subcommittee to present our views concerning H.R. 2869 and the reauthorization of the CFTC.

It is abundantly clear that H.R. 2869 seeks to send a message to the public that Congress intends to act swiftly and firmly to rectify perceived defects in the regulation of future markets. We do not dispute the value of this message. Although we believe that allegations of abuse in our markets are more a matter of perception than fact, it is undeniably in our interest to ensure that public confidence in the integrity of the markets is maintained.

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While we support the message, as well as the concept of strengthening the regulatory system, we differ fundamentally as to the means chosen to achieve those objectives. For the first time, the bill seeks to impose Congressional mandates in a level of detail traditionally reserved for the CFTC and the exchanges -- the experts familiar with industry practice, customer needs, emerging technology and all of the other practical realities of day-to-day life. The bill ignores many important differences among the regulated markets and the customers that use them. The net result, we believe, would be to weaken rather than enhance the efficiency of the system. These weaknesses would be exploited by our overseas competitors and, in the final analysis, the American public would be worse off under H.R. 2869 than it is today.

It is both premature and unnecessary to regulate with the specificity contained in H.R. 2869. The present regulatory structure, with its flexibility, has allowed United States markets to provide internationally envied risk-shifting and price discovery forums that have been of immeasurable value in achieving price certainty and stability to farmers, oil producers and refiners, industry, the financial community and, ultimately, consumers. The system works. Reaction to press reports in January of a Justice Department investigation into commodity trading in Chicago demonstrates just that. Virtually every commodity exchange in the country has performed an extensive review of its own trading rules and practices over the last six months. Many constructive recommendations for regulatory reform have been offered by the NYMEX Regulatory Review Task Force and the special review committees formed by other exchanges.

The essential conclusion of the NYMEX Task Force was that the appropriate method to regulate against trade practice violations was through rules designed to prohibit improper conduct, an audit trail sufficient to recreate the sequence of trading, surveillance and compliance systems that identify trade practice violations and a disciplinary process that both punishes violators and serves to deter future violations. On dual trading, the Task Force recognized that dual trading was not a problem in itself. The Task Force, therefore, did not recommend banning this otherwise beneficial practice merely because of an apparent perception that it created a conflict of interest.

Until studies determine with certainty that such an action would not threaten the efficiency and liquidity of the markets, ultimately harming the commercial and public participants that the regulatory structure is designed to protect, the composition of the markets should not be tampered with. Thus, the Task Force offered many recommendations for strengthening the regulatory structure, but at the same time attempted to ensure that the markets maintained their highly respected pricing capabilities.

We respectfully request that Congress take the same measured approach in its reauthorization of the CFTC. On a positive note, it appears that many of the provisions of H.R. 2869 are consistent with the NYMEX Task Force's recommendations. We believe that they represent a reasonable effort at fine-tuning the Commodity Exchange Act and system of CFTC and exchange regulations that govern the industry. Our specific comments on those provisions are contained in an addendum to this testimony.

The dual trading and audit trail provisions of the bill, on the other hand, seem to represent a "shoot first and ask questions later" approach. They place at risk the efficiency and viability of our markets. We are fearful of such a method of legislation. Once the damage is done to the markets, it will be irreversible. Accordingly, we respectfully request that the Subcommittee reject those provisions of the bill.

To briefly digress, trading populations on commodity exchange floors are comprised of three groups of participants: floor brokers who exclusively execute customer orders, floor traders who serve exclusively as market-makers, absorbing risk by trading for their own accounts, and so-called "dual traders" who may both execute customer orders and trade for their own account on the same day. These three components, though not necessarily comprised of equal numbers of traders, are the three legs of the stool that support the open outcry auction market system. That system, in turn, provides the most efficient pricing system in the world. On an average day, there are approximately 450 traders on the NYMEX floor, spread among crude oil, heating oil, gasoline, propane, platinum and palladium futures trading and crude oil, heating oil and gasoline options trading.

The liquidity provided to the markets by dual traders varies depending on a wide range of circumstances. It varies between commodities, times of the trading day and between exchanges. In New York, for example, the limited number of qualified floor traders makes each individual's contribution to the market more significant and less replaceable. In our Crude Oil market, during the most active period, 65% of traders are dual traders. They trade 35% of the total volume as market-traders for their own account. They also provide a significant amount of brokerage service for customer orders.

I am not going to suggest that if you cut the dual trading leg from the stool that the stool will immediately fall. What I am suggesting is that, in light of the vast amount of domestic commerce that relies upon the stability of the stool for support, any proposal that includes a provision for an immediate or contingent market-wide termination of dual trading should not be adopted.

Prudence dictates that before such action is taken, Congress must have a clear understanding with respect to each individual market, how much of the liquidity provided by dual traders would be lost if dual trading were eliminated and/or how much of the brokerage capability would disappear if dual traders chose to trade solely for their own accounts. Congress must also have a clear understanding of the effects that such fundamental market changes would have on such things as bid/ask spreads, the ability to execute large commercial customer orders with limited market impact, and the smooth and orderly flow of customer orders through an already stretched, limited pool of qualified floor brokers. Studies by the CFTC and CBOT on these subjects are already under way and others can be expected to begin soon.

At the present time, there is no evidence that dual trading is an evil in itself. All that has been said is that the practice creates the perception of a conflict of interest. We submit that dual trading alone is not a problem. Like other potential conflicts of interest, it can be regulated through the strict enforcement of rules designed to prevent the abuse of any conflict that may arise.

For your benefit, I would like to describe how that system works, including how some of the recommendations of the NYMEX Task Force and provisions of H.R. 2869 might enhance the system without putting its efficiency at risk.

There are three primary methods by which a customer's order can be taken advantage of on the floor of an exchange. The customer's broker can "trade ahead" of that order, depriving his customer of the best market price, while reserving that benefit to himself. The broker can disclose his customer's order to another, permitting that other person to benefit at his customer's expense. And the broker can deprive his customer of a competitive market price by prearranging a trade or taking the opposite side of the orders without the customer's permission. Each of these practices is explicitly prohibited by rules currently in force at every commodity exchange.

There are many ways to ensure that traders comply with these rules. Begin with the principle that in handling customer orders, floor brokers are fiduciaries. Accordingly, they owe their customer the duties of care and loyalty. These duties represent much more than theoretical, ethical concepts; they are part of the practical reality in the commodities market. We have many, many private attorneys general as customers in our market. The energy markets, like many other commodities markets in this country, are comprised predominantly of sophisticated, commercial participants, including integrated oil companies, producers and refiners, as well as large investment funds. These participants actively monitor futures and cash market price movements on a moment-by-moment basis, through screens showing the NYMEX ticker, by using more than one broker on the Exchange floor and by active communication with upstairs traders throughout the industry.

They are more than ready to, and do, challenge the price at which orders are filled on the floor if they believe that they did not receive the best ultimate execution. They have the power of a civil action as private attorneys general if their broker has breached his duties of care and loyalty. But they have much greater power as a practical matter -- the power to move their business to a different broker, including a broker who does not dual trade.

The Exchange also has trade practice surveillance programs to ensure compliance with its trading rules. These programs begin with the audit trail. The NYMEX audit trail is created by a pit card system that requires each selling broker to submit, on a transaction-by-transaction basis, hard data for each trade. Each trade is then independently time-stamped by an Exchange official, and this time-stamp forms the basis for sequencing the audit trail.

It is the only audit trail mechanism of its kind, providing the most accurate, complete and tamper-resistant procedure for audit trail creation.

The pit card submission procedure enables NYMEX to continuously input all trades into its computer system throughout the day, and display these trades on computer screens located on the Exchange floor and in the Exchange's Compliance Department for on-line review. From a self-regulatory standpoint, we believe that same-day peer review and Compliance Department scrutiny provide not only an effective audit trail, but also a significant deterrent to certain trade practice abuses.

NYMEX also uses trade information from the pit cards to construct a Streetbook -- NYMEX's trade register. The Streetbook provides a chronological trade sequence based upon minute-by-minute exchange time-stamping of pit cards. With advancements in computer technology, the Streetbook information is available on interactive computers for selective study and review by the Compliance Department.

In addition, the Compliance Department employs computer assisted surveillance tools to monitor trading. Most relevant is the "1C/4C" program that is designed to detect potential cases of "trading ahead." The 1C/4C program identifies each instance in which a broker trades for his own account before or after executing his customer's order, at a better price than he received for his customer. Since its implementation in August 1988, the 1C/4C program has resulted in the opening of 19 formal investigations, of which five have led to disciplinary actions. Three already have resulted in sanctions for floor trading violations, while several others are still pending.

The final step in the chain is an effective disciplinary procedure to punish violators. NYMEX's Task Force made several recommendations very similar to the committee structure and publication of sanctions requirements contained in H.R. 2869. In addition, the Task Force recommended special training for disciplinary committee members, and special penalties for fraud and deceit involving customer orders, such as the potential suspension of the privilege of executing customer orders. NYMEX believes that this regulatory framework of rules, audit trail, surveillance/compliance and discipline is sufficient to deter, detect and punish trade practice violations.

If it is not, or if any one of the components is not up to par, the CFTC already has the power to sanction an exchange. We submit that the appropriate sanction is not a ban on dual trading that would have unintended negative consequences on the markets, but a sanction more traditionally imposed through the CFTC's existing powers.

Moreover, the approach to dual trading in H.R. 2869 is overly simplistic. First, volume does not equal liquidity. 7000 contracts in a market with a small deliverable supply of the underlying commodity represents a different level of "liquidity" than 7,000 contracts in a market with a large deliverable supply where large transactions may be necessary to hedge a single physical transaction. One of the key elements to liquidity is the ability to execute a large order without disruption to the market. Thus, in a market such as crude oil, where a 500 or 1000 lot order may be necessary to hedge a single transaction of 500,000 or one million barrels of oil, the 7,000 contract volume threshold cannot possibly demonstrate a liquid market.

Likewise, the proposed volume threshold does not take into account the differences in volume in different contract months. Thus, a contract's total volume may be 7,000 contracts, yet all months beyond the spot month may not be very liquid. The proposed bill would eliminate the dual trader's market-making capabilities from all months, not just the purportedly "liquid" months. This problem is multiplied geometrically for options markets where in each listed month both puts and calls are traded for a series of strike prices. As the 7,000 contracts are spread among the various series of puts and calls, the liquidity in each becomes less and the need for increased market-making provided by dual traders is more apparent.

The approach is simply contrary to traditional self-regulation where the needs of particular markets can be thoroughly addressed and sufficient flexibility maintained to maximize all interests affected.

In sum, two proposals have been floated to address the perception problem associated with dual trading. NYMEX's Board of Directors met yesterday and would like to offer a third proposal in which COMEX concurs in principle. The two pending proposals, offered by the proposed bill and by the Chicago exchanges tie a market's privilege to have dual traders to audit trail accuracy and/or market trading volume. We submit that this is the wrong approach. If there is a lack of confidence in the ability to police the markets to protect the public, then strengthen that ability. The punishment of banning dual trading will hurt market participants, not help them. It will make markets less efficient and drive up the cost of doing business.

For these reasons, NYMEX offers the following alternative proposal:

(a) Congress shall mandate that the CFTC, with the full consultation of each exchange, shall determine an appropriate standard for each exchange, to ensure the accuracy of that exchange's audit trail. The CFTC shall take into account the strengths and unique characteristics of each system's method of audit trail creation.

(b) The Commission, with the full consultation of each exchange, shall develop criteria to determine whether each exchange is in compliance with its standard.

(c) To ensure that the traders on the floor of the exchange, who actually initiate the audit trail, are held to the highest standards, Congress shall mandate that the Commission, through regulation, shall require exchanges to adopt rules mandating each floor member to adhere to strict, objective standards for audit trail accuracy. The exchange rules shall provide specific and harsh sanctions for failure to comply, including, ultimately, the loss of dual trading privileges and/or suspension from membership.

We believe that this proposal, more than any we have heard to date, most directly confronts the issues at hand. All brokers should be held to the highest standards in audit trail creation accuracy. An accurate audit trail is the optimum means to examine the trading of the individual for violations such as trading ahead of customer orders.

Under this proposal, Congress will legislatively ensure the highest audit trail standards. The CFTC will retain its self-regulatory authority to ensure that the standards are carefully tailored to achieve Congress' goals while preserving the competitiveness of the U.S. futures markets. The exchanges benefit by being permitted to address the issue in a forthright and direct manner. If an individual cannot adhere to strict audit trail creation accuracy standards, the individual should be punished. Finally, and most importantly, with this proposal and the many other surveillance and compliance improvements that are being implemented, the institution and the trading public benefit from systems capable of detecting trading abuses and by retaining the most liquid and efficient futures markets to conduct their hedging and price discovery. On top of that, Congress will have ensured that each participant in the process is fully accountable for the integrity of the system.

I thank you for your time and consideration. I welcome any questions that you may have.

3390B

(Attachments follow:)

New York Mercantile Exchange

Addendum to
Statement of Z. Lou Guttman
Chairman of the Board of Directors
New York Mercantile Exchange

Before the
United States House of Representatives
Committee on Agriculture
Subcommittee on Conservation,
Credit and Rural Development

The New York Mercantile Exchange ("NYMEX") respectfully submits the following additional views on the provisions of H.R. 2869.

SECTION 101 - DUAL TRADING

NYMEX's position on dual trading is fully set forth in the Statement. Dual trading is not inherently evil. It allows for additional flexibility in the marketplace, allowing exchange members to service customers' needs and/or provide liquidity as the needs of the market change. Until studies can be completed that determine what effect a restriction on dual trading will have on market efficiency and liquidity, no such restriction should be enacted.

The only problem with dual trading is that it creates the perception of a conflict of interest. We submit that the proper way to deal with a perception problem is to ensure that no conflict can be abused. The proper way is through efficient rules, an accurate audit trail, aggressive surveillance and compliance programs, and strong discipline. We believe that NYMEX has these components in place and that they will be further strengthened through the adoption of the recommendations of NYMEX's Regulatory Review Task Force and many of the other provisions of H.R. 2869.

In addition, NYMEX recommends that the following additional measures be taken:

(a) Congress shall mandate that the CFTC, with the full consultation of each exchange, shall determine an appropriate standard for each exchange, to ensure the accuracy of that exchange's audit trail. The CFTC shall take into account the strengths and unique characteristics of each system's method of audit trail creation.

(b) The Commission, with the full consultation of each exchange, shall develop criteria to determine whether each exchange is in compliance with its standard.

(c) To ensure that the traders on the floor of the exchange, who actually initiate the audit trail, are held to the highest standards, Congress shall mandate that the Commission, through regulation, shall require exchanges to adopt rules mandating each floor member to adhere to strict, objective standards for audit trail accuracy. The exchange rules shall provide specific and harsh sanctions for failure to comply, including, ultimately, the loss of dual trading privileges and/or suspension from membership.

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SECTION 102 - TRADING AMONG MEMBERS OF BROKER ASSOCIATIONS

At NYMEX, members of formal broker affiliations, known as Member Firms, are already subject to regulation. All trades between or among them are treated as cross-trades and monitored as such. NYMEX believes that this trading restriction is sufficient to prevent trade practice violations while still permitting customers' business to be executed opposite the maximum number of willing counterparties to maximize the customers' ability to participate in the market.

NYMEX does not oppose legislation or regulation requiring that broker affiliations be registered and their trading monitored. However, NYMEX does not believe that legislation limiting trading among affiliated brokers should be imposed until, first, the CFTC drafts a definition of "affiliated broker" so that it is clear to whom any trading restrictions would apply, and second, a study of the scope and use of affiliations is completed and a determination of the necessity of additional trading restrictions is made.

The CFTC is expected to complete its study of broker affiliations early this fall. Accordingly, legislation on this subject should be deferred at least until this study is completed.

SECTION 201 - AUDIT TRAILS

NYMEX concurs in the need for an accurate audit trail capable of permitting the recreation of trade sequence. An accurate audit trail is a necessary component of an effective compliance effort.

The time frame for the audit trail, the method for determining compliance, and any sanction for non-compliance should be left in the hands of the CFTC, to enable the strengths and unique characteristics of audit trail creation mechanisms to be accounted for.

NYMEX's audit trail is created by the pit card submission procedure -- a procedure which requires transaction-by-transaction submission to the Exchange of the hard data used to create the audit trail. (The Exchange's audit trail also has several other components to reconstruct trading activity and detect improper conduct, including order tickets, transfer sheets and the Time and Sales Report.) NYMEX believes that the pit card system is the most effective means to create an accurate, tamper-resistant audit trail, yet it is the most burdensome on floor traders.

The pit card system records transactions in the following manner. After each transaction is executed on the floor of the Exchange, the seller is required to submit to an Exchange official a pit card, identifying the buying and selling brokers, the commodity, month, quantity and price of the transaction. The Exchange official immediately time-stamps all pit cards upon receipt and that time-stamp becomes the official time of the trade.

In terms of audit trail accuracy, there are several benefits of the pit card system, all of which derive from one simple fact -- pit card times are real trade transaction times. Pit card times are not imputed by computer programs based on assumptions and probabilities. They are not broker entries of execution times. They are time-clocked by Exchange officials, independently recording the time of each transaction. Because the pit card must be submitted directly after a trade execution, the ability of a broker to alter or amend that information without alerting the Exchange and documenting the basis for the change is eliminated. Other systems permit brokers to retain, review and create or recreate their records for a substantial period after the transaction without detection.

The benefits of the pit card system bring with them procedural difficulties in achieving the same empirical "accuracy" rates as other systems. Under the pit card system, a trader must: (1) complete his trade, (2) write-up the pit card, (3) submit it to an Exchange official, and (4) have it time-stamped, all within 60 seconds. To illustrate: suppose a broker has a market order to sell 100 contracts of crude oil futures for a customer. As he starts the process of execution, he is able to fill only 20 contracts with one broker at an initial price and, therefore, continues to offer to execute the balance of the order. Within moments, his offer is taken, in partial fills of 20 lots each, by 4 other brokers. Assuming that the process took less than one minute to complete the execution of the customer order from the first partial fill through the last, there is still a possibility to comply with the one-minute time-stamping requirement. (Although the broker could stop the execution process after the first partial fill to submit a pit card, this would be inefficient and might result in significant economic harm to his customer.) At this point, the broker must begin to write pit cards and submit them to the Exchange. Finally, still within the 60 second period, the Exchange official must retrieve the card and time-stamp it, otherwise compliance with the one-minute standard technically will not be achieved.

Although NYMEX believes this is the most efficient audit trail creation system, it is easy to see why compliance with the one-minute standard is hardest. It is also clear why the CFTC should be left the flexibility to determine whether a 30-second standard, at the risk of losing the benefits of the pit card system, is an objective worth pursuing.

NYMEX has investigated, and will continue to investigate, the availability of technology that can improve the speed and accuracy of the process by which its audit trail is created. We have examined the possibility of a hand-held electronic pit card, but it is not technically feasible at this time. Congress must be confident that the exchanges will implement electronic technology as it becomes available. However, it must leave the flexibility to the exchanges to determine the type of technology and the timetable for implementation that meet the trading practices and physical facilities of each exchange.

SECTION 202 - TELEMARKETING FRAUD

NYMEX expresses no view on Section 202 of the proposed legislation.

SECTION 203 - UNDERCOVER OPERATIONS AND ENFORCEMENT

Under Sections 8 and 12 of the Commodity Exchange Act, the CFTC already has the powers granted to it under Section 203 of the proposed legislation. Accordingly, this aspect of the legislation is unnecessary.

SECTION 204 - SELF REGULATORY ORGANIZATION DISCIPLINARY COMMITTEES AND GOVERNING BOARDS

Disciplinary Committees

NYMEX's Regulatory Review Task Force has recommended changes to the NYMEX disciplinary committee structure virtually identical to those contained in Section 204 of the bill. There are two notable exceptions. First, NYMEX would not allow its staff members to serve on disciplinary committees. Second, rather than dividing disciplinary committee members into the two categories of floor and non-floor, NYMEX would divide its committees into the four categories that represent its membership -- futures commission merchants, commercial trade houses, floor brokers and floor traders. Under this system, a majority of the committee would still be comprised of members from categories different from the respondent.

NYMEX's Regulatory Review Task Force also recommended wider distribution of notices of sanctions involving serious violations and that persons found to have committed certain offenses be prohibited from service on the Exchange's disciplinary committees and Board of Directors. NYMEX would work with the Commission to develop appropriate regulations to govern these matters.

Board of Directors

NYMEX does not believe that Congress needs to legislate public participation on exchange governing boards. Presently, NYMEX has three public directors on a 19 member board. Choosing the most efficient means to run a corporate organization, including the balance between the detached views of outsiders and the hands-on and possible self-interested views of insiders should be left to the organizations themselves.

SECTION 205 - REQUIRED REGISTRATION OF FLOOR TRADERS

NYMEX has no objection to Section 205 of the proposed legislation.

SECTION 206 - ENHANCEMENT OF REGISTRATION REQUIREMENTS

The only objection that NYMEX has to Section 206 of the proposed legislation is the striking of the phrase "within ten years proceeding the filing of the application" in Sections 8a(3)(D) and (E) of the Act. NYMEX believes that ten years is a sufficiently long period of time to warrant the presumption of rehabilitation.

SECTION 207 - ENFORCEMENT OF CIVIL MONEY PENALTIES

NYMEX expresses no view on Section 207 of the proposed legislation.

SECTION 208 - ETHICS TRAINING FOR REGISTRANTS

NYMEX has no objection to Section 208 of the proposed legislation, except to state that for Exchange member registrants, the training sessions should be administered by the Exchange.

NYMEX already had an extensive broker training course which includes a session on the legal and ethical responsibilities of floor traders. NYMEX also requires all Members to adhere to the Ethics Guidelines for Members of the New York Mercantile Exchange, a copy of which is attached, that was adopted last fall by the Exchange's Board of Directors.

SECTION 209 - NATIONWIDE SERVICE OF PROCESS AND VENUE

NYMEX strenuously objects to the provisions of Section 209 of the proposed legislation insofar as it is unclear whether an action involving both a contract market and any other persons as defendants may be brought in any jurisdiction or must be brought in the jurisdiction where the contract market is located. Provided that clarifying language indicating the latter intent is added, NYMEX would have no objection to this provisions.

SECTION 301 - DEFINITION OF FOREIGN FUTURES AUTHORITY

NYMEX expresses no view on Section 301 of the proposed legislation.

SECTION 302 - SUBPOENA AUTHORITY

NYMEX expresses no view on Section 302 of the proposed legislation.

SECTION 303 - COOPERATION WITH FOREIGN FUTURES AUTHORITIES

NYMEX expresses no view on Section 303 of the proposed legislation.

SECTION 304 - INVESTIGATE ASSISTANCE TO FOREIGN FUTURES AUTHORITIES

NYMEX expresses no view on Section 304 of the proposed legislation.

SECTION 305 - DISCLOSURE OF INFORMATION RECEIVED FROM FOREIGN FUTURES AUTHORITIES

NYMEX expresses no view on Section 305 of the proposed legislation.

SECTION 306 - DISCLOSURE OF INFORMATION TO FOREIGN FUTURES AUTHORITIES

NYMEX expresses no view on Section 306 of the proposed legislation.

SECTION 401 - AUTHORIZATION OF APPROPRIATIONS

NYMEX supports the permanent reauthorization of the Commodity Futures Trading Commission.

SECTION 402 - EFFECTIVE DATE

NYMEX has no objection to Section 402 of the proposed legislation.

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NEW YORK MERCANTILE EXCHANGE
Four World Trade Center, New York, NY 10048 212/938-2879

ETHICS GUIDELINES FOR MEMBERS OF THE NEW YORK MERCANTILE EXCHANGE

I. STATEMENT OF POLICY

The purpose of these guidelines is to set forth the policy of the New York Mercantile Exchange regarding ethical responsibilities for members of the Exchange and conflicts of interest and potential conflicts of interest for members, directors, and committee members.

Any failure to abide by these guidelines may be deemed a violation of Exchange Rule 8.53 (F) (prohibiting conduct detrimental to the best interests of the Exchange) and/or may constitute grounds for removal of a member from a Committee or the Board of Directors.

II. INTRODUCTION

Members of the New York Mercantile Exchange enjoy rights and privileges that enable them to participate in, and benefit from, the business transacted on the Exchange. Along with these rights and privileges, members have a responsibility to conduct their business affairs in compliance with the Rules and By-Laws of the Exchange, and with the laws of New York State and the United States. General policy statements applying to all NYMEX members are:

- A member must be familiar with the Exchange's rules, and must stay current with any changes to the rules.
- Should there be a question concerning a particular practice, open discussion will likely resolve the issue. Senior Staff and Exchange Committees are readily available for discussion and resolution of issues.
- The Exchange will seek to deter and punish any member engaged in any practice which is unethical or illegal. Should the Exchange discover any business being done in any other than an absolutely proper manner, appropriate disciplinary action will be taken.

III. COOPERATION WITH COMPLIANCE STAFF

The NYMEX is a self-regulatory institution, and has a responsibility to its members and the public to assure that its rules are followed. The Compliance Department of the Exchange is the vehicle which the Exchange employs to investigate possible violations of NYMEX rules and by-laws.

To help fulfill the Exchange's self-regulatory responsibility, each member should, and is required to, cooperate with Compliance personnel in performing their duty. Records must be turned over if requested, and interview appointments must be kept, or rescheduled in advance. If a member observes or learns of a rule violation, it is his obligation to turn the matter over to Compliance to investigate.

By virtue of the sensitive nature of its investigations, the Compliance Department is required by Federal law to be independent of the Exchange's membership. Exchange members and committee members may request that an investigation be conducted, but cannot direct that one be conducted, and cannot direct what steps to take in pursuing an investigation.

A member (other than the subject of an investigation) also is not entitled to know the status of any investigation, because the rules require that such information be held in confidence by the staff. A member subject to an investigation may properly request to know whether or not an investigation is ongoing or completed, but not specific steps or actions taken. A member's effort to obtain information concerning an investigation may be interpreted by Staff as an attempt to affect the course or outcome of an investigation. The independence and integrity of the Compliance Department may be adversely affected by such effort.

In the event a member has a question about the Department's procedures, or takes issue with any action by a Compliance staff member, he should approach the supervisor or department head with his complaint. If the member cannot get a satisfactory explanation to his questions, the Exchange's President and Executive Vice President, or the Compliance Review Committee may be approached with the complaint or question.

IV. SERVICE ON THE BOARD OF DIRECTORS

Directors of the Exchange are elected by the membership, and are entrusted with the duty to maintain the well-being of the Exchange. When a director accepts his seat on the Board, he agrees to place the Exchange's interests ahead of his own, and to act fairly and honestly on behalf of the institution. The director has a fiduciary duty under law to assure that his actions meet the standards of honesty and ethics that are expected of any person who accepts such a position of trust.

A director must avoid conflicts of interest between his personal affairs and the affairs of the corporation. In fact, a director must make every reasonable effort to avoid the appearance of a conflict of interest.

Conflicts of interest, and apparent conflicts, may arise in many areas, and a director must always be diligent to guard against them. However, several areas of Exchange life present more potential for conflicts of interest. These include: service on Committees, particularly as a Chairman or Vice-Chairman; trade relationships with other members; and interaction with staff officials. Conflicts may take the form of, but shall not be limited to:

- Accepting Rewards for Official Service
- Influencing Committee Actions for Personal Gain
- Directing Staff Efforts for Personal Gain or Favors

A reward for service on the Board or on a Committee is prohibited in any form, whether the reward is direct or indirect. Efforts to circumvent this prohibition — to give the appearance of legitimacy to a practice which is illegitimate — will result in prompt and appropriate disciplinary action when uncovered.

A director carries the authority and weight of his office with him in all aspects of his day-to-day Exchange life. On a Committee his opinions should be expected to carry great weight. As a result, persons or firms who are interested in the outcome of a Committee's decision, may seek to influence the thinking of a director serving on the Committee. Such influence may properly consist of intellectual discussion; but when influence extends to a potential personal financial or business reward, the director must recognize that his office may be compromised, and should disclose the reward to the Committee.

A Floor Member director likewise carries great weight with his fellow Floor Members. This authority can be used to set an example to protect the integrity of the public. However, it improperly may be used to intimidate, as well — to seek advantageous trades, or to offer impunity to others to break the rules. Commission sharing arrangements may be used to channel a reward to a director for some official favor.

It is improper for a director to seek or accept special favors for personal benefit from a staff member. Asking staff for special favors to do personal work improperly diverts their time from the Exchange's work. Entering into personal employment negotiations with a staff member must be disclosed by the Director and staff member to the president, so that they do not confuse the employee's loyalties, and compromise his independence and trustworthiness.

A director's duties are many and complex, and questions may arise about the propriety of some action. The director is not expected to know it all, but he is expected to discuss his questions about his duties with the President, Executive Vice President or General Counsel when those questions arise.

V. SERVICE ON EXCHANGE COMMITTEES

Much of Exchange life revolves around the efforts and decisions of its Committees. The use of Committees is intended to ensure that the membership has a voice in the important affairs of the Exchange. Service on a Committee is a way of giving back some benefit to the Exchange and its members, and carries with it a responsibility to avoid making decisions based on self-interest rather than the interest of the Exchange and its members.

If a member is called on to make a decision in a Committee which might have an impact on his or his firm's trading; on the location of his physical facilities; or on his business relationship with a customer, he should disclose the specifics of his possible conflict to the staff liaison or general counsel before voting.

A Committee member serves because he is interested in the well-being of the Exchange. It is never appropriate to serve with the expectation or intent to reap a reward or financial benefit from any Committee service.

Service on the Committee is not an appropriate selling point when seeking new business from customers, and it is not appropriate to seek to improve a customer relationship by voting a particular way on a Committee. Once again, service is to benefit the Exchange, not to reward the Committee member.

In the event a Committee member has a question about any potential conflict of interest arising from his duties of committee service and his business activities, it is his responsibility to bring that question to the full Committee or to a senior member of the NYMEX staff such as the President, Executive Vice President or General Counsel, for resolution. Relying on ignorance of the rules of conduct will not be viewed as a reasonable and satisfactory defense in the event a member is found to have improperly served on a Committee or participated in a Committee decision.

VI. PROHIBITION AGAINST DISCLOSING CONFIDENTIAL INFORMATION

No member may disclose to any person confidential information that he learns by virtue of his service on a Committee (such as the Control Committee or Business Conduct Committee) or on the Board of Directors. Confidential information includes advance knowledge of anticipated regulatory action; positions or intentions of market users; information which, if disclosed, may have an impact on price or other market conditions; proposed rules, rule amendments, or contracts or contract changes; or any other information which is conveyed as being confidential information in the course of a committee's or board's function.

VII. SERVICE ON THE FLOOR COMMITTEE, THE SETTLEMENT PRICE COMMITTEE, AND AS RING CHAIRMAN

Service on a Committee which can have an immediate impact on trading, market prices and on member and investor confidence carries with it special obligations. Such Committees include the Floor Committee, and the Settlement Price Committee. Special requirements also apply to the selected few Floor Members who are chosen to represent the trading rings as Ring Chairmen. Members of these groups have the most frequent and visible contact with the Floor Membership, and are perceived to be symbols of self-regulation and the serious intent of the Exchange to police itself.

Floor Committee members and Ring Chairmen enforce rules governing decorum and orderliness of trading. Their decisions can immediately affect a member's profit or loss, or the direction of the market. In a less direct way, the example that Ring Chairmen and Floor Committee members set, in how they conduct themselves in their personal business and in performing their Committee functions, will determine whether members respect the rules of decorum and fair and orderly trading, or feel free to disregard them. Members of the Settlement Price Committee also carry significant powers to affect the market, and are themselves examples for the rest of the floor community.

In sum, members of the Floor and Settlement Price Committees, and Ring Chairmen, must act fairly, in good faith, and with no personal motivation driving their actions. Rather, their motivation should be market oriented, to protect the integrity of the marketplace.

If any member feels that a Floor or Settlement Committee member or Ring Chairman is abusing his authority — not because he made an innocent mistake or error in calculation — he has every right to report the abuse to the Committee Chairman, the Exchange President or Executive Vice President, or to the Vice President for Compliance.

VIII. BUSINESS NEGOTIATIONS OR RELATIONSHIPS WITH EXCHANGE STAFF

A member may not negotiate or discuss any potential employment or business relationship with any member of the Compliance Staff, or with any other officer or employee of the Exchange, where the member knows that such staff person is engaged in an investigation or specific regulatory function concerning the member, unless the member discloses such discussions immediately to the Vice President of the Compliance Department or to the Exchange President.

CONCLUSION

Membership on the Exchange, and service on the NYMEX Board or on a Committee are positions of honor requiring ethical actions. Fellow members and the public at-large require and demand a high standard of conduct and service.

If at any time, any member has a question concerning his duties of membership or Committee service, he should and must raise the question with the Committee affected or with a senior-level Exchange officer.

TESTIMONY OF BENNETT J. CORN, PRESIDENT
COFFEE, SUGAR & COCOA EXCHANGE, BEFORE
SUBCOMMITTEE ON CONSERVATION, CREDIT AND RURAL DEVELOPMENT
HOUSE COMMITTEE ON AGRICULTURE

July 18, 1989

Good afternoon, Mr. Chairman. My name is Bennett J. Corn. I am the President of the Coffee, Sugar & Cocoa Exchange in New York City.

Our Exchange, which has been in existence since 1882, is the preeminent market in the world for trading futures and options in coffee, sugar and cocoa. Our contracts are heavily used by commercial interests engaged in the production, exportation, distribution and processing of these three commodities.

Over the years we have seen tremendous growth in trading on our Exchange. In just three years, our total volume has more than doubled, from 4,[illegible],27[illegible] contracts in 1985 to 10,019,664 contracts in 1988. This growth represents a solid vote of confidence from our market users. One of the reasons for that confidence is that we have constantly striven to maintain active, liquid markets, where trading is conducted in accordance with rules and practices designed to assure fair, orderly and competitive trading.

Maintaining our preeminent position as an international market has required us continually to improve the services and facilities we offer commercial traders and public investors. As volume increases and as technology advances, we have repeatedly reviewed our situation and committed additional resources to the extent necessary to meet both present and futures needs. For example, in the early 1980's we installed a major computerized information system to support our compliance program and our market surveillance efforts, as well as the overall management of the Exchange. This system was praised by the CFTC as being state of the art at that time. Today, our needs have outgrown its capabilities. Therefore, our Board of Managers last year authorized the Exchange staff to develop whatever improvements are necessary and budgeted the funds for the purpose. Earlier this year, the Board increased budgeting for computer equipment, systems and facilities by approximately $5,000,000, which represents an increase in our combined capital and expense budget of about one-third.

At the same time, in response to published reports about investigations of possible trading abuses in the futures markets in Chicago and New York, our Board appointed a special committee composed of members from all of the trading sectors represented in our markets to review all of our rules and practices, and all of our compliance procedures, with a view to identifying possible areas of improvement for recommendation to the Board. The report of that committee is expected to be presented to the Board in September.

These actions are undertaken as a matter of discharging our self-regulatory responsibility. However, they are also undertaken as a matter of enlightened self-interest. This Exchange operates with powerful competition from eight rival exchanges overseas, most notably the London Futures and Options Exchange, which actively trades futures on coffee, sugar and cocoa. As I said earlier, our markets enjoy very heavy participation by commercial interests from all over the world, but a majority of our market users also trade on the London Exchange. It is very important for us to maintain marketplaces of the highest quality, for if we do not, it is a very simple matter for our largest customers simply to take their business overseas.

The basic point is that we have the same goals as this Subcommittee. We have to. Our livelihood depends on them.

We are very concerned, however, that in a well-intentioned effort to benefit the trading public, the Bill presently pending before this Subcommittee (H.R. 2869) will actually have the opposite effect. Unfortunately, in its most important provisions, the Bill proceeds from an unproven and, we believe, incorrect premise. It then attempts to solve a problem which has not been shown to exist, and to do so in a way that could seriously damage the U.S. futures markets instead of strengthening them.

Furthermore, we support granting the CFTC with broad discretion to regulate the futures industry. Among other things, the Commission should be free to take into account differences among the exchanges when developing regulatory standards. The Bill would have the opposite effect, in that it would impose detailed requirements on the Commission that would erode its discretion.

Section 101 of the Bill would in effect ban dual trading in markets having an average daily trading volume of 7,000 contracts, unless the relevant exchange can show that its audit trail satisfies requirements that may well be impossible to meet. We would be affected in that at present our sugar futures trade well over 7,000 contracts per day, while coffee and cocoa futures trades just under that amount.

"Dual trading" is not defined in the Bill, but we take it to mean the practice whereby a floor broker trades both for his own account and the accounts of customers during the same trading day. While that practice might be perceived to contain the potential for conflicts of interests, the fact is that it is carefully regulated by CFTC and exchange rules designed to protect the interests of the customers.

There are instances where those rules are violated, and we take disciplinary action against those who are found guilty. However, there has not yet been brought forward any evidence to suggest that in fact the practice of dual trading is actually a major source of customer abuse. To the contrary, as the staff of this Subcommittee has already stated, dual trading violations are relatively easy to detect; and, if the practice were banned, those who are bent on illegally taking advantage of their customers may well resort to techniques that are much more difficult to detect.

On the other hand, dual trading provides important benefits to the market. We do not presume to speak for other exchanges. However, we can state categorically that dual trading plays an important role on our Exchange. In the very brief time since the Bill was introduced, we have not been able to study the matter in any great depth. Nevertheless a quick, preliminary survey indicates that in our sugar futures market, over 50% of the floor traders are dual traders, and those dual traders accounted for as much as 80% of the volume on the trading days we reviewed. If dual trading were banned, there is no way to say at this time what the effect would be. Some floor members would presumably opt only to trade for their own accounts, while others would presumably trade only for customers. Finally, some floor members may find that it is not economically attractive to carry on only one business or the other and accordingly withdraw altogether.

Whatever does happen, trading volume could be significantly affected. That in turn could reduce liquidity, which would be reflected in wider spreads between bids and offers, and in a reduced ability of the market to absorb price changes continuously and in an orderly manner. If liquidity suffers, buyers will pay more and sellers will receive less than they should. Public traders will be disadvantaged. Commercials will incur higher costs, which of course will be passed on to the consumers in the supermarkets.

In our case, the problem will be compounded by the fact that if our markets lose liquidity to any significant extent, market participants will find our foreign competitors more attractive. If and to the extent they shift their trading to the foreign exchanges, the problem will be compounded.

Liquidity is an extremely important feature in the competition between our markets and those overseas. The New York sugar futures market is regarded as having a major advantage over its London rival precisely because we have a large cadre of independent floor traders, which London does not have. Indeed, just last year the London Futures and Options Exchange held a reception in New York for floor traders on our Exchange in an effort to entice them to London to make that market more liquid.

Another consequence of banning dual trading is that more experienced floor members may decide to trade for their own accounts as locals, and only the less experienced will continue to handle customer business. This could lead to a lower quality of execution for customers.

Please understand that I am not saying that all of these dire consequences will occur if this Bill is passed. What I am saying is that at this point no one can be sure what may happen, and there is no reason to take the risk of harming the markets in order to solve a problem which has not been shown to exist. It is premature to take drastic action without having had an opportunity to identify the problem and analyze the potential effects of that action. The approach taken by the Bill is a little bit like firing a revolver in a dark room merely because there is a suspicious sound.

For all these reasons, we respectfully urge that the dual trading ban be eliminated from the Bill. The CFTC presently is conducting a thorough study of dual trading. The GAO is conducting its own study of the futures markets, and the U.S. Attorney in Chicago has been reported to be conducting an investigation of certain trade practices. It would make far better sense to wait until the results of those studies and that investigation are released before deciding whether any legislation regarding dual trading is warranted, and, if so, what the precise nature of that legislation should be.

In any event, if the Congress concludes that the U.S. trading public requires the abolition of dual trading, then the conclusion should apply as much to trading on foreign exchanges as on U.S. exchanges. In other words, if dual trading is to be banned, then no one should be permitted to solicit or accept orders from U.S. customers for execution on foreign exchanges that permit dual trading.

Those are our general observations regarding the proposed ban on dual trading. In view of the very brief period that has been available to study the Bill, we are not in a position at this time to comment on its provisions in full detail. However, there are a few specific points which I shall take the liberty of calling to your attention.

First of all, the Bill establishes a threshold trading level of 7,000 contracts at which the dual trading ban would apply, but then gives the CFTC the power to change that level in particular cases. There is no basis for the 7,000 figure, which is completely arbitrary. Determining an appropriate level requires the application of expertise to a number of factors, such as the extent of commercial utilization, the normal bid-asked spreads and the average transaction size. If there is to be a threshold, it should be set in the first instance by the CFTC.

Further, if there is to be a threshold, it should apply to each month, not to the entire contract. It makes no sense to ban dual trading in an illiquid back month, just because the volume in all months combined exceeds some predetermined level.

Among the exceptions from the proposed ban would be trades to correct errors at the opening of the market. There is no reason why the correcting of errors should be limited to the opening. If a broker discovers an error during the course of the day, he should be allowed to get out of it as soon as possible. He should not be forced to carry it overnight and thereby be at a risk of substantial loss. This is particularly true in commodities such as those traded on our Exchange, where there is active trading in foreign markets before our opening, and prices can move significantly away from where our market closed the previous day.

Another exception to the proposed dual trading ban would be where a floor broker in effect has the consent of his customer to engage in dual trading. Brokers typically receive orders through a number of futures commission merchants, which in turn may be acting on behalf of hundreds of customers. In order to make a customer consent requirement manageable, the burden should be on the customers to object to dual trading, rather than requiring the floor brokers or the FCMs to solicit consents from the customers. In other words, a floor broker should be allowed to engage in dual trading unless a customer directs otherwise. This could be done at the time an account is opened and at any time thereafter.

In addition, floor brokers generally have no direct contact with the vast majority of customers. The broker is selected by the FCM to whom the customer gives the order. Accordingly, if a customer directs that his orders may not be executed by a floor broker who also trades for his own account, the FCM will have the responsibility to place that customer's orders only with floor brokers who do not engage in dual trading.

The Bill would direct the CFTC to exempt any exchange from the dual trading ban if it can show that its audit trail "(i) can detect any and all instances of trading violations which the Commission determines to be attributable to dual trading, and (ii) is fully verifiable."

This Exchange has and continues to strive to make enhancements to its Audit Trail System (ATS) to maintain a high level of effective self-regulation. In that regard, the Exchange's Compliance Department and systems staff have an on-going dialogue to improve the structure of our system. We monitor our ATS system to see that it is functioning effectively and assigning transaction times. We believe that we have an effective time recording system in place, and we regularly review source records.

We believe we have one of the most comprehensive systems in place at any exchange to prevent the alteration or fabrication of trading records. We collect trading cards from members on the floor at the end of every half-hour bracket period, and we maintain these collected trading cards in a secure area where they are not available to unauthorized persons. Accordingly, trading cards come into the Exchange's possession frequently throughout the trading day and are thereafter controlled to prevent alteration. Each of our trading cards has sequentially prenumbered lines, and all trading cards are sequentially prenumbered. This prenumbering of lines and cards allows our compliance staff to monitor the accuracy of traders' records and to verify the information contained on those records against the Exchange's price change register and original customer order tickets.

With respect to the sequencing of transactions, our Compliance Department has standard reviews specifically designed for the prompt detection of violations, and we have adequate sanctions for violations of record keeping and reporting requirements. Further, we monitor compliance with record keeping and reporting rules in the course of any other standard reviews conducted by the Compliance Department. Accordingly, we believe we have adequate procedures to test the accuracy of source records and to prevent the alteration or fabrication of source documents.

In addition to having prenumbered sequential trading cards on which all lines are numbered, we also require that floor members record all of the trading they do (both for themselves and for customers) in sequential order. Every trade executed by a member must be sequentially recorded on his trading cards, whether it is for the member's own account, for a house account, or for a customer. As a result, the trading cards which we collect from our members at the end of every half-hour bracket period contain that member's record of all business he did at the ring in sequential order. The documents enable us to reconstruct each individual member's trading very accurately against the transactions occuring at the ring, thereby providing us an excellent audit trail capability. This enables us to effectively police our dual trading rules and to detect and deter potential abuses.

It is important to note that our record-keeping system differs from many other exchanges. For example, on other exchanges, members' transactions for their own accounts are recorded on trading cards, while customer transactions are merely noted on trading tickets. Further, those exchanges require members to record their personal purchases on one side of a card and sales on another side of a card. Therefore, they do not have a single record that shows all proprietary and customer trades in sequence, whereas we do.

While our audit trail is extremely effective, we are concerned that the standards set forth in the Bill may well be impossible to comply with. There is no system we are aware of in being or on any drawing board that can detect "any and all" instances of any violation. Furthermore, there is no indication whatsoever as to what it means to require that a system be "fully verifiable." The Bill is structured so that an exchange would be banned from dual trading during the period it takes for the CFTC to act on a petition for relief -- a period that could last months or even more. If the CFTC eventually determines that the exchange has met its burden, there must then be a 90-day waiting period after the CFTC reports its findings to Congress. Only then could the exchange resume dual trading; but by that time, liquidity could already have been lost, and the harm could already have been done. There is no need for such a result. The exchanges should be permitted to have dual trading unless and until the CFTC determines that the requisite standards have not been met.

Section 201 of the Bill would require, among other things, that every exchange must have the capability to time the execution of all transactions within an increment of one minute by the end of one year, and within an increment of 30 seconds by the end of three years.

Arriving at an appropriate standard for exchange audit trails and developing a methodology to capture execution times without unduly disrupting floor trading have been among the most difficult regulatory issues the CFTC and the exchanges have had to contend with. After years of study, debate and controversy, the CFTC adopted a regulation that in effect requires exchanges to record the time of execution of all trades within increments of no more than one minute in length. Each exchange is permitted to develop its own system for meeting the requirement. In compliance with this regulation, the exchanges adopted a number of different systems. Some use manual recordation of times. Others use complex computer logic to assign execution times. Our Exchange adopted one of the computer-driven systems early in 1988.

As an informal yardstick, the CFTC has stated that it expects the systems to achieve an accuracy level of 90%. Our system is still being tested in operation, with problems being identified and corrected. We are confident that it will meet the 90% standard in the near future, and we are striving toward that goal.

In the meantime, what is most important for purposes of monitoring our markets is that, under the systems and procedures we presently have in effect, we can (and when appropriate do) completely reconstruct a floor broker's trades, in sequence, so that, for example, instances of dual trading violations can be readily detected.

It is extremely premature to require at this time that the timing increments be reduced from one minute to 30 seconds. In the first place, there is no evidence to suggest that the reduction would improve an exchange's ability to sequence its trades to an extent that would significantly improve its ability to monitor trading activities. In addition, there is no indication as to the costs that may be incurred, or the disruptions in trading that might result, from going to a 30-second standard, and there has been no analysis of whether those costs and disruptions are justified by whatever benefits may be derived.

Section 201 also suffers from the fact that it contains the starkest example of micromanaging the CFTC in the Bill, in that it lifts, almost verbatim, language out of CFTC Regulation 1.35 and raises it to the status of a statutory requirement, thereby depriving the CFTC of the flexibility to amend its own regulation.

Section 102 of the Bill would make it unlawful for one member of a broker association acting for a customer account to trade with another member of the same association trading for his own account, and for any one member of an association from effecting more than 25% of his own trades in any month with another member of the same association.

First of all, I call your attention to the fact that not every exchange recognizes the concept of broker associations.

We do not. We have rules regulating activities of brokers having certain relationships, but we believe the nature of the rules should depend on the particular relationship. There is nothing wrong *per se* with allowing related brokers to trade with each other, whether for customer accounts or their own accounts. The objective should be to ensure that all trades are openly offered and available to everyone in the pit or ring, and our rules are designed to that end.

Furthermore, we believe that a 25% limit, such as is proposed in the Bill, would be very difficult for members to monitor. Among other things, when a broker makes a bid or offer, there is no indication as to whether he is acting for his own account or that of a customer. Therefore, the opposite broker or trader has no way of knowing whether the 25% limit would be applicable.

Most importantly, we believe that whatever rules are adopted should be left to the discretion of the exchanges. We are not aware of any evidence to suggest the need for Congressional legislation in this area.

Section 202 of the Bill would provide that no one who solicits an account from a customer by telephone may enter an order for that account during a cooling-off period of three days, with certain exceptions. We assume that this provision will be the subject of comment from others. Nevetheless, I would like to point out that the effect of this provision could needlessly be to prevent a customer of a legitimate brokerage house from taking advantage of an investment opportunity. In the commodity markets, prices can move very rapidly, and during the three days a customer is required to cool off, he may miss a good opportunity to make a profit. Such a customer is being punished because of the fact that some boiler room operators take advantage of their customers through high pressure sales tactics.

One other observation is that there does not seem to be any basis for distinguishing U.S. futures and options from other investment products. If a cooling-off period such as this is adopted for the protection of U.S. traders, it should apply as well to securities, foreign futures and all other instruments that are sold for investment purposes.

Section 203 would require the CFTC to "continue" to cooperate with appropriate Federal agencies in conducting investigations. While cooperation with other agencies is of course desirable, to mandate the Commission to do what it is already doing seems superfluous and unjustifiably demeaning to the Commission.

Section 204 would require the CFTC to adopt regulations requiring exchanges to have disciplinary committees, specifying the composition of those committees and requiring the establishment of a schedule of "major violations," the commission of which will render an individual ineligible for service on the governing board or disciplinary committees of any exchange or registered futures association. In part, this provision is superfluous, because the CFTC already has (and has long had) regulations in place requiring disciplinary committees and setting standards for their composition. To go into the kind of detail specified in the Bill is for Congress to engage in micromanagement of the Commission to an extent that is contrary to the entire concept of appointing administrative agencies.

One provision of Section 204 would specifically require that a majority of persons on a disciplinary committee must be of a different "trading status" than the respondent in any proceeding before the committee. Such a requirement could also result in depriving a disciplinary panel of the expertise it should have in passing on questions that require intimate familiarity with trade practices and standards. As it happens, the Business Conduct Committee on our Exchange is presently composed of three floor members and four non-floor members, and it did not take any statutory or regulatory requirement to produce that result. Rather, it was the result of our applying our judgment as to what was appropriate for our Exchange under all the circumstances. Each exchange should be left to make its own decision in matters such as this, subject, of course, to CFTC oversight.

Section 204 would also require 20% of the members of every exchange board to be comprised of "outside members."

This seems like another example of unnecessary micromanagement of the CFTC and the exchanges. As it happens, our rules have long provided for diversity in the membership of our Board, including public membership. There is no need for a statute to require this.

If the Congress nevertheless decides that board diversity should be mandated by law, we suggest that, rather than setting detailed requirements in the statute, Congress might consider the approach followed in the securities laws for securities exchanges -- specifically in Section 6(b)(3) of the Securities Exchange Act of 1934, which requires that each securities exchange "assure a fair representation of its members in the selection of its directors and administration of its affairs and provide that one or more directors shall be representative of issuers and investors and not be associated with a member of the exchange, broker, or dealer." Presumably the analogue to an "issuer" in the commodities markets would be a market user, such as a grower, manufacturer, processor or dealer.

Section 204 of the Bill would require registration of floor traders. We support this provision because it will help the CFTC and the exchanges to keep persons with criminal records and other undesirables out of our industry. We do suggest, however, that the CFTC (and any registered national futures association to which the CFTC delegates the registration function) be encouraged to adopt a temporary registration procedure, so that properly qualified persons are not deprived of the opportuity to function as floor traders during the sometimes lengthy period that their applications for registration are being processed.

Section 208 of the Bill would require ethics training for all Commission registrants. We strongly support the concept of ethics training for industry participants. Indeed, our Exchange and several of the other New York exchanges already require an ethics course for new members. On the other hand, we belive that unnecessary duplication of requirements should be avoided. We therefore suggest that the Bill be amended to provide an exception for persons who take suitable ethics training under the auspices of a self-regulatory organization.

Section 401 of the Bill provides for reauthorizaiton of appropriations under the Commodity Exchange Act for only two years. We are disappointed that the period is so short. We believe that the CFTC has demonstrated that it is entitled to a permanent place in the U.S regulatory scheme. Over the past years it has built up the expertise necesary to reconcile the goal of protecting the public with the goal of accommodating the reasonable needs of the business. Frequent reauthorizations divert the Commission from its regulatory mission because of the heavy demands that are placed on its modest resources by the need to prepare for the hearings and to respond to

Congressional inquiries. Accordingly, we urge that the Bill be amended to grant the Commission permanent status.

Mr. Chairman, that concludes my testimony. I appreciate the opportunity to testify before you today. If you have any questions, I will be happy to answer them if I can, and to submit the answers later if I am not able to provide them now.

Thank you.

ROBERT E. FINK
CHAIRMAN OF THE BOARD
COMMODITY EXCHANGE, INC.

Mr. Chairman, members of the Subcommittee, I am Robert Fink, Chairman of the Board of Commodity Exchange, Inc. (Comex). Comex is the world's most active metals futures market and the fourth most active of all futures markets in the United States. Our exchange provides an arena for trading futures contracts on gold, silver, copper and aluminum, and options on gold, silver and copper. Users of our markets include speculators, commercial and industrial hedgers, and major financial institutions -- both in the U.S. and abroad.

I am very pleased to have this opportunity to share Comex's views on the English/Coleman bill, H.R. 2869.

We are very concerned about the approach that has been taken in the bill. Particularly objectionable is the appearance that Congress intends to deal with issues such as dual trading and audit trail that are already subjects of comprehensive regulation and to legislate details that should be determined through rulemaking by the Commodity Futures Trading Commission. This course of dealing with futures industry regulation seems to be at odds with statements made by the chief sponsors of the bill at their June 28 press conference and the provision in the bill that is aimed at establishing the Commission as a permanent independent regulatory agency.

On May 30, 1989, the CFTC transmitted a proposed schedule of administrative actions to Chairman Leahy of the Senate Committee on Agriculture, Nutrition, and Forestry. The Commission stated that, among other things, it would: propose regulatory changes regarding audit trails and dual trading, if any are warranted, by September 1989; publish for public comment during the 4th quarter of FY '89 a proposed rule that will cause exchanges to bar, for an appropriate period of time, those members with significant disciplinary records from serving on exchange disciplinary and oversight panels (a final rule is expected by the end of December 1989); and complete the assessment of the information on broker associations in August 1989, and then determine what regulatory initiatives, if any, are needed. In addition, the Commission has stated that it intends to review the adequacy of representation on exchange governing boards as part of its rule enforcement review process and to recommend further action if the boards are found not be be broad-based.

We believe that the prudent course to be followed is to allow the Commission to proceed with its efforts on these issues and develop an administrative record that can serve as a basis for a review by this Subcommittee of those issues. Therefore, we do not support the sections of H.R. 2869 which deal with dual trading (Section 101), audit trails (Section 201), broker associations (Section 102), and disciplinary committees and governing boards (Section 204) and believe they should be dropped from the bill at this time. If the Subcommittee is dissatisfied with the eventual actions taken by the Commission in these areas, it can hold hearings and take whatever action its deems necessary at that time. The precedent of congressional involvement in the hands-on regulation of these markets, prior to CFTC action, is not a course that was contemplated when the CFTC was established and is a course that has not been followed to date.

During this reauthorization process, the Subcommittee might more properly ask how the Commission has discharged its regulatory oversight responsibilities with respect to its areas of concern. In Comex's view, comparative statistics dealing with the size of the exchange compliance staffs, expenditures on compliance programs, and monetary sanctions against exchange members for a variety of trading abuses demonstrate surprising disparities among the exchanges. Regulatory reviews performed by the CFTC of the exchanges' compliance efforts also disclose differing degrees of complexity and breadth of investigations they conduct and of the violative acts uncovered and sanctioned. It is difficult to understand how a single regulatory mechanism can expect to stride smoothly toward the goal of fair and honest trading when its tools of measurement tolerate so many standards of performance among its moving parts.

In addition to the foregoing, we would also stress that to properly evaluate the need for new legislation in the areas of dual trading and audit trail, the air must be cleared of presumptions of the lack of market participants' integrity. Absent the return of indictments or any other indication of wrongdoing attributable to dual trading and suggestive of inadequate audit trails, we believe that legislative action, particularly that aimed at restricting dual trading, is premature. In fact, until more is learned of the findings resulting from these investigations, we cannot even discern whether the types of conduct which are the subject of the investigations were not already detected by the respective exchanges' surveillance programs and sanctioned through their disciplinary processes.

Finally, the Subcommittee should also be aware of the introspection that the industry has undergone since the disclosure of the federal investigations in Chicago and New York. The industry as a whole has engaged in a reevaluation of existing practices, and the exchanges have formed advisory panels to obtain guidance in this process. Congressional intervention before completion of this process will significantly undermine the efforts of numerous well-intentioned, dedicated individuals who are seeking the same goal as this Subcommittee -- restoration of confidence in the marketplace through enhanced customer protections.

DUAL TRADING AND AUDIT TRAILS

Section 101 of the bill, in essence, would prohibit dual trading in any contract market which has a daily average volume of 7,000 contracts or more. The bill expressly exempts from the ban (i) spread trades executed by a floor broker for his own account, (ii) trading by a floor broker on the opening to correct errors made in his account the previous day, and (iii) trades executed by any broker whose customer specifically authorizes the broker to engage in dual trading. This section of the bill also authorizes the CFTC to exempt an exchange from the ban if the exchange demonstrates to the CFTC that its audit trail is "fully verifiable" and "can detect any and all instances of trading violations which the Commission determines to be attributable to dual trading."

In tandem with the dual trading prohibition, Section 201 of the bill would require each exchange to meet the one-minute trade execution time recordation requirement within one year of enactment of the bill and a thirty-second trade execution time recordation requirement within three years of enactment. This section of the bill further directs the CFTC to determine (i) whether these measures have enabled rapid reconstruction of an accurate, verifiable record of transactions to provide for effective rule enforcement and (ii) whether use of improved technologies can improve the accuracy of recordation and market reconstruction.

Congressman English stated at the June 28 press conference at which the bill was initially described that these provisions have been proposed because "none of the exchanges have reached the one-minute standard" and, as a result, detection of every instance in which a dual trading floor broker engages in trading abuses cannot be guaranteed.

Comex takes issue both with the assumptions underlying this legislation as well as the specific provisions embodied in the legislation.

The threshold issues which must be addressed by the Subcommittee prior to passage of any legislation are, first, identification of the objectives of the legislation and, second, a determination whether the mechanisms prescribed by the legislation are the most effective means of achieving these objectives. In our view, adoption of the proposed legislation is inadvisable when both of these questions are answered.

It has been suggested that dual trading presents an inherent conflict of interest and poses an opportunity for abuse by wrongdoers. While the objective of banning dual trading appears to be the eradication of potential trading abuse, we believe that the abolition of this type of trading would eliminate only one type of abuse - direct frontrunning - which is already unlawful, without affecting any other trade practices that disadvantage customers. Each of the other (also currently prohibited) methods of effecting similar results such as the withholding of customer orders and the disclosure of customer orders in exchange for profit-sharing - indirect forms of front-running - would remain unaffected by the proposed ban. In fact, your own Subcommittee Staff Director has advised the Subcommittee, during the May 4 briefing, that trading abuses will not be curtailed as a result of prohibiting dual trading since

> ...[t]here are only two trade violations which a single individual can accomplish alone. Both of those abuses can also be accomplished between two or more individuals.
>
> These violations are trading ahead of a customer and taking a position against a customer.
>
> These two violations when executed by a single person are among the easiest to detect in an accurate audit trail. They stick out like a sore thumb. (Emphasis added.)

Thus, the abolition of dual trading will not further the cause of customer protection. Such a ban could, and probably would, make detection of some abusive trading practices more difficult to detect. Moreover, prohibiting or limiting dual trading poses serious disadvantages to users of the markets.

For example, the presence of dual traders in a trading ring supplies flexibility that enables floor traders to respond to changing market conditions, *e.g.*, providing immediate additional brokerage capacity in a fast market, thus enhancing the efficiency of the market. This flexibility would be lost if dual trading were to be abolished.

Dual traders are also viewed by market users who were interviewed by the Exchange's Special Advisory Panel as providing better brokerage services because of their greater trading expertise and sensitivity to market forces. They are not mere order fillers and have their own capital at risk in the market. The Exchange's Panel has also been advised through interviews of traders, brokerage houses and market users that the abolition of dual trading is likely to increase the cost of brokerage services.

In the course of these interviews, all interviewees, without exception, stated that they used (and the substantial majority indicated that they sought out) dual traders for the execution of their orders, notwithstanding the potential conflict of interest dual trading presents. While not every interviewee was prepared to endorse dual trading unreservedly, not one interviewee articulated the view that the disadvantages of dual trading merited its abolition.

Moreover, and most importantly, the effect of dual trading upon market liquidity has not yet been fully studied. It is imperative to determine the effect of the presence of dual traders upon liquidity in each market prior to the adoption of restrictions which may have an irreversible impact upon the viability of our markets. These markets are not the same; each has its own specific characteristics.

These factors are all important to users of our markets and bear consideration in weighing the merits of curtailing dual trading by legislation.

We believe that it is inarguable that an effective audit trail is a cornerstone to detection of trade practice abuses, of which direct frontrunning is only one. For that reason, the exchanges have committed substantial resources, both in terms of manpower and dollars, to developing comprehensive methods of capturing trade data and analyzing the data to facilitate investigation of exchange members' trading activities. As part of the audit trail program, the CFTC has monitored our progress and provided advice on how to improve these systems, particularly in the area of surveillance, to better perform our obligations with respect to the one-minute standard currently embodied in CFTC Regulation 1.35. In fact, the CFTC has been actively engaged in determining the verifiability of the data currently collected, the extent to which absence of data hinders an exchange's (or the CFTC's) ability, to reconstruct market activity and the use to which the data is currently put. In light of these ongoing efforts, it is unclear what objectives this portion of Section 201 seeks other than to reiterate the mandates under which the exchanges and the CFTC have been operating since 1987.

The second prong of the audit trail section, which would halve the required time of recordation to thirty-seconds within three years of enactment of the bill, has been proposed without putting forth any empirical evidence of the potential benefits to detection or the feasibility of constructing the systems necessary to capture this data. Absent evaluation of such information, we believe the Subcommittee would be acting precipitously if it were to adopt such an approach.

The third provision of the audit trail section of the bill, authorizing the CFTC to exempt exchanges from the dual trading ban, is drafted so ambiguously as to create a "Catch-22" under the current regulatory structure. Since 1987, the Commission has been reviewing each exchange's audit trail program to determine its effectiveness in enabling adequate market reconstruction, its verifiability, and the extent to which it has been integrated into an exchange's surveillance program to detect trading abuses. Understanding that even the most high-tech system cannot capture every single instance of unlawful trading (such as an isolated one-contract trade executed one time), the Commission has been developing what, in its expertise, is a standard of performance which, assumedly, will apply to all exchanges. Rather than continue to allow the Commission to define the standards by which exchange audit trails are most appropriately measured, the bill appears to hold the Commission (and resultantly, the exchanges) to what may be an unworkable standard, that of requiring the development of a fully verifiable system, capable of catching all instances of certain trading abuses. This result improperly pre-empts the Commission's authority and may render the exemption meaningless.

The thrust of our observations on the dual trading and audit trail provisions of the bill is easily distilled. We believe that the only effective means of combating abuse of customer orders is to implement (1) mechanisms to capture data that enable tracking of the flow of all orders from the time of placement through execution; (2) means of analyzing trading data to detect patterns of unlawful activity; (3) use of the data to prosecute traders involved in unlawful activity; and (4) imposition of substantial disciplinary sanctions against those adjudged to be rule violators. Absent any one of these four aspects of an exchange's obligations to the investment community, customers will not be protected to the extent they should be.

The current provisions of the Commodity Exchange Act mandate the performance of these obligations through rule enforcement reviews of each exchange and subject the exchanges to enforcement proceedings if they have failed to enforce their rules, including those pertaining to dual trading and audit trail. As the Subcommittee is aware, enforcement proceedings can result in the revocation of a contract market's designation - a strong sanction in anyone's view. If an exchange is not complying with its obligations, we would expect that strong action would be taken. Rather than supporting this administrative process, this legislation improperly disadvantages customers from the onset - without any evidence of wrongdoing at an exchange - by virtue of a measure that is harmful to those sought to be protected by all participants in the regulatory process. Congress should not be legislating to combat a perception; a negative perception affects the exchanges' business and it is in their best interest to combat it, as they are doing.

This provision of the bill is further flawed in that its focus is diverted from the actual wrongdoers. For example, the bank teller who embezzles bank funds has gained access to those funds by virtue of his employment. The corporate officer who illegally profits from his non-public information gained that information by virtue of his employment. In either case, when the crime is disclosed, the perpetrator is brought to justice. In neither case is the bank or the corporation closed for business.

If this bill is enacted, it will not be the trader who has illegally taken advantage of customer orders - the violator - who would be subjected to sanctions above and beyond those currently available; rather, it is the marketplace that would be restructured. Nobody, however, can speak with any degree of certainty to the effects of that restructuring. It is at best unwise, and potentially disastrous, to proceed on this path without further study. Modern technology and international competitive zeal deprive you, and us, of the luxury of allowing you to be wrong on this issue, for liquidity once lost is almost irretrievable.

Clearly, we do not condone abusive trading practices. We believe, however, that the existing audit trail systems adequately disclose trading abuses; that the audit trail systems will continue to be improved in an evolutionary manner as new or improved technologies become available; that the industry is becoming convinced, as Comex has been for several years, that an effective surveillance and compliance program is necessary, and benefits all concerned; and that the incremental benefit to be gained by moving to a 30-second trade time recordation requirement does not justify the costs involved and could divert efforts from the development of real-time, on-line systems.

The tools are in place to deal with the abuses of dual traders. It is up to the exchanges to demonstrate their willingness to impose serious sanctions for serious violations and for the Commission to ensure that these efforts are undertaken. If those commitments are not made, the data generated by the exchanges' audit trails are merely so many squiggles on a piece of paper. Comex has a long history evidencing its commitment to enforcing its trading rules, and the industry as a whole is now adopting a much stronger regulatory presence. Extensive studies have been undertaken and will continue to be commissioned for one simple reason - it is in our self-interest to do so. Given that self-interest and our expertise in what we do, we should be allowed to see these efforts through to fruition. At that point, your evaluation of progress would be welcomed.

BROKER ASSOCIATIONS

Proposed Section 102 of the legislation would prohibit members of broker associations from executing customer orders opposite the personal accounts of members of the association (or the house account of the association) and would limit the amount of trading which could be done between members of the association (presumably without regard to whether the trading is for their own accounts or for customers) to a fixed percentage (as percent) of the associates' and the association's trading activity. Assuming that a clear definition of "broker association" can be devised, Comex has no objection to adoption of a prohibition against trading customers' orders (defined by CFTC regulations as a type "4" trade) opposite house (defined by CFTC regulations as a type "2" trade) or personal (defined by CFTC regulations as a type "1" trade) accounts. In fact, Comex has had such a rule in place for seven years, treating this type of transaction as an impermissible cross-trade.

The second part of this section of the bill, which limits trading between associated brokers to a fixed percentage of trades, poses serious problems to customer interests and should not be adopted. The type of limitation proposed presupposes that there is always sufficient liquidity to enable the execution of any customer order, regardless of the size of the order or the depth of the market in the contract month to which the order applies. This assumption is not borne out in all markets or in all contract months, thereby giving rise to the possibility that a broker could not fill a customer order simply because he had already traded his fixed allotment of trades opposite other members of his association that day. For that reason, we believe that no statutory limitation should be placed on the execution of customer orders against other customer orders.

A more effective approach to this issue would be exchange-adopted rules requiring the registration of all affiliations on the exchange on which the group is trading. Each exchange should then be responsible as part of its compliance program (subject to CFTC review through its rule enforcement programs) to monitor the customer trades executed between affiliated members to assure that no unlawful activity has been undertaken. In light of the exchanges' already-stated commitment to pursuing this course, legislation of this nature is unnecessary.

PERIOD OF REAUTHORIZATION

We support a framework for reauthorization that will allow the Commission to effectively continue fulfilling its responsibilities. The existing system is a significant drain on

CFTC resources and delays needed changes and developments. Congressional oversight of the agency should be ongoing and not simply "ginned-up" for reauthorization. Likewise, the Commission should submit recommended legislative changes as the need arises and not wait to present them in a reauthorization package. At this point in time, no one is questioning the continued existence of the CFTC, and it should not be held hostage to a laborious reauthorization process.

UNDERCOVER SURVEILLANCE

Section 203 of the bill amends the Commodity Exchange Act to expressly authorize the Commission to participate in joint-federal agency investigations - a practice which has been ongoing for years - and notes that these investigations may encompass "undercover operations." Absent any restrictions on the Commission's investigative techniques or authority in the current language of Section 8(a) of the Commodity Exchange Act, this supplementary provision is unnecessary.

GOVERNING BOARDS AND DISCIPLINARY COMMITTEES

Proposed Section 204 would (1) require that the board of each exchange and the NFA include a fixed percentage of "outside members" (as defined by the CFTC); (2) require the CFTC to issue regulations calling for the establishment of a system of exchange disciplinary committees; (3) require the CFTC to issue regulations requiring exchanges to establish and make publicly available a schedule of its "major" violations; and (4) bar members of an exchange who have engaged in "major" (as defined by an exchange) violations of that exchange's rules from serving on that exchange's board or disciplinary committees for a period of time to be specified by the CFTC.

A. Composition of the Board

Pursuant to by-law, the Comex Board of Governors is comprised of seven representatives of the trading floor (the Floor Group), seven representatives of futures commission merchants (the Commission House Group), seven representatives of the metals trade (the Trade Group), three non-members, and a member Chairman elected by the full membership of the Exchange.

the metals trade (the Trade Group), three non-members, and a member Chairman elected by the full membership of the Exchange.

The Exchange's intent in establishing this form of governance was to ensure diversity of views during deliberations on all policy issues, to provide for representation of all sectors of users of our markets, and to obtain guidance from individuals unrelated to the Exchange and its members on matters affecting the public interest.

In many exchanges' experience, it is often difficult to solicit service by non-market participants who will offer a substantial degree of independence from the leadership of the exchange, who are willing to develop expertise relevant to the issues at hand, and who are capable of committing the time needed to assist in what is often protracted decisionmaking. For that reason, we believe that the designation of any fixed percentage of non-member seats on a board or committee through legislation without regard to the difficulties in obtaining "quality" representation is a misguided intrusion into exchange corporate affairs and is merely an expedient method of demonstrating representation of the public interest without substance.

We would also object to legislation designed merely to assure that persons other than floor traders (such as individuals employed by wire or trade houses) are represented on governing boards. While we believe that an exchange's decisionmakers must represent all facets of the investment community to assure that the exchange's decisions are made in good faith and that the public's interests are promoted above those of the membership, the actual composition of a board should not be a subject of federal legislation. Instead, as is currently the case, the focus of oversight, whether by Congress or the CFTC, should be upon the decisions reached by an exchange's governors to determine whether the exchange has exercised its self-regulatory responsibilities properly.

B. Composition of Disciplinary Committees

Comex takes issue with the proposal vesting the CFTC with authority to establish a structure for exchange disciplinary committees as well as with the statements of one of the bill's sponsors that a conflict exists when floor members pass judgment on their colleagues and that this "conflict leads to leniency".

First, it has been Comex's experience that the floor members seated on our disciplinary committees are often the harshest critics of their peers, the most expert at ferreting out trading abuses, and not at all reluctant to mete out sanctions that other members may view as harsh.

Second, while we agree that to fulfill its rule enforcement responsibilities, the SROs' disciplinary committees should include members of "groups" other than that of the respondent (such as floor vs. off-floor members), we believe that this issue of committee composition, like that of board composition, is not a proper subject of federal legislation.

Similar to our Board composition, by practice all disciplinary committees at Comex are comprised of representatives of each of our membership groups, and members of adjudicatory panels are appointed by the Board with representation of each of these, as well as the non-member groups. Notwithstanding our own adherence to this system, we believe that specification of the types of individuals serving on disciplinary committees by legislation is an improper intrusion into exchanges' governance and erroneously focuses on the appearance of the deliberating body rather than on the results of its deliberations. Instead, as is already the case, federal oversight should be concerned with the acts of an exchange's disciplinary committees to determine whether the exchange is properly enforcing its rules and is adequately sanctioning violators of those rules. To do otherwise places form over substance and diverts attention from the main thrust of oversight, which is the adequacy of the exchanges' self-regulatory programs.

As a technical matter, we further note that the specific proposal calling for the establishment of hearing panels composed of "a majority of persons who are of a different trading status than the respondent" (e.g., floor member vs. off-floor member) will require the establishment of separate hearing panels for each case, thereby rendering more difficult this exchange's objective of developing consistent approaches to rule violations and sanctions within our disciplinary committees. This result must be anticipated if the legislation is adopted and serves to undermine the objective we assume is sought by the Subcommittee.

C. Disqualification for Rule Violations

Under our rules, any individual who has been fined by Comex in excess of $1,000 is disqualified from service on the Exchange's disciplinary committees for a period of two (2) years after the sanction has been imposed. It is our understanding that other exchanges have adopted, or are in the process of evaluating proposals to adopt, similar disqualification provisions for their disciplinary committees and/or governing boards. In light of the likelihood that this issue will be resolved by all of the exchanges without legislation, in a manner best suited to each exchange's interpretations of its rules, it is our view that this provision of the bill is unnecessary.

TELEMARKETING FRAUD

Comex supports the three-day "cooling-off" period for first-time speculative customers who have been solicited by telephone contained in Section 202. Such a provision should not be disruptive and should discourage some of the telephone scam operators. In the same vein, we have expressed our support for the Telemarketing Fraud Prevention Act of 1989 pending before the House Energy and Commerce Committee.

REGISTRATION

Comex does not object to legislation that would require the registration of floor traders, and Comex also does not object to supplementation of the disqualification provisions currently embodied in the Commodity Exchange Act, with the exception of the proposed insertion of language into Section 8a(3)(k) of the Act regarding "conduct inconsistent with just and equitable principles of trade," since this type of violation is applied by the exchanges without uniformity and does not address specific behavior similar to the other offenses enumerated in the Commodity Exchange Act.

ETHICS

For several years, Comex has required all new floor trading members to complete a floor practices trading course administered by the Exchange to assure that new Comex floor members are familiar with their obligations on the trading floor. This course currently involves classroom instruction (and examination) on floor trading rules such as open outcry, after hours trading, cross-trading, prearranged trades, dual trading and priority of orders.

Several months ago, Comex began to explore the possibility of incorporating ethics instruction into our ongoing training program or, alternately, joining with several other New

York exchanges in sponsoring a joint program. We are also considering expanding the program to involve all new exchange enrollees and requiring all current members to complete the ethics component of the course. While we do not believe that federal legislation is required to assure that this type of training is provided to exchange members, Comex does not object to the proposed provision of the bill which would call for the issuance by the CFTC of regulations requiring registrants to participate in such training programs.

COMMISSION PROPOSALS

We do not object to the Commission's legislative proposals on (1) nationwide service of process; (2) international cooperative enforcement efforts; (3) removing the requirement that the CFTC consider net worth and ability to continue in business in determining the amount of a civil monetary penalty; and (4) providing for an automatic suspension of registration and a trading prohibition upon failure to pay a civil monetary penalty.

(Attachments follow:)

Technical Questions Raised by Certain Provisions of H.R. 2869

Our analysis of the language of the English/Coleman bill raises the following questions. Given the limited amount of time we have had to analyze the bill, this listing is not intended to cover all potential technical questions.

New Section 4j (1) (A)--Section 101 of the bill--If there are to be criteria for modifying the volume threshold, shouldn't there be criteria for establishing the threshold, i.e., the 7,000 contract provision? Can the Commission ever determine that the banning of dual trading created "undesirable price volatility" or "unacceptable widening of bid-ask spreads"? What are "undesirable price volatility" and "unacceptable widening of bid-ask spread"? What does "otherwise threatens the public interest" mean? Clarification of these terms is needed if this provision is to have any meaning; without such clarification, it is impossible to analyze the provision.

New Section 4j (1) (B) (vii)--Section 101 of the bill--Who is the customer who must execute the written waiver of the dual trading ban--is it the FCM, the ultimate customer, the pool operator, or each pool participant? Is a waiver needed from each and every customer?

New Section 4j (1) (D)--Section 101 of the bill--The criteria for the exemption may be impossible to satisfy, depending on how the CFTC reads "attributable to dual trading." What does "fully verifiable" mean? Are these criteria consistent with the criteria contained in new Section 4g (2) (B) (iv) (a) that look to the ability to "rapidly reconstruct an accurate, verifiable record of the transactions executed..."

What is the reason for delaying the effectiveness of such an exception from the dual trading ban until the expiration of 90 days after the date of transmittal of a report to the congressional agriculture committees regarding the exemption? Such a long period could destroy the utility of the provision.

New Section 4g (2) (B) (i)--Section 201 of the bill--It appears that the term "physical" in this section is intended to be "an exchange for physicals."

New Section 4q--Section 202 of the bill--Is there any reason not to exempt a customer who already has a commodities account with another firm?

New Section 8c (6) (A)--Section 204 of the bill--What is a "schedule of major violations"? What is the logic underlying the requirement of public access to an exchange's schedule of major violations?

COMEX Policy Statement on Dual Trading and Audit Trails

Commodity Exchange, Inc. (COMEX) believes that the frontrunning of customer orders, whether perpetrated through dual trading or other means, and the development and use of accurate audit trail data are each significant issues deserving of regulatory attention. The nexus between the two issues is the ability of an exchange's audit trail to detect trade practice abuses, such as frontrunning, and the willingness of exchanges to sanction those members who have breached their fiduciary duty to the public.

The requirements of audit trail compliance should rest squarely on the shoulders of those directly responsible for the accuracy of trade time data--the traders themselves. Thereafter, the responsibility to use this data and to prosecute wrongdoers becomes the obligation of the exchanges. Unfortunately the provisions of H.R. 2869 affecting dual trading and audit trail systems, as well as other proposals which would link the continuation of dual trading at an exchange to the demonstration by that exchange (rather than each of its members) of its attainment of specified audit trail accuracy levels, fail to follow this course. Instead these proposals penalize market users as well as all traders, even if a trader fully complies with an audit trail standard.

Dual trading makes important contributions to the marketplace including increased liquidity, flexibility, and better execution of customer orders. Proposed restrictions on dual trading are likely to have negative consequences for our markets and the service we render to the public without measurable improvements to market integrity. Therefore, dual trading, absent findings of illegal activities by a trader, should be left intact.

We do believe that an individual's dual trading privileges should be subject to revocation if that trader has violated rules intended to protect the marketplace. For that reason COMEX supports a statutory provision that would require the CFTC to mandate that each domestic futures exchange establish a schedule of sanctions for any of its members who violate the one-minute audit trail trading time recordation requirement, which must include the suspension of an exchange member's dual trading privileges.

COMEX envisions this system working as follows. A minimum acceptable level of compliance with the one-minute standard for each member of a domestic exchange would be established by the CFTC. Thereafter, each exchange would be required to submit to the commission a schedule of graduated sanctions which it intends to invoke against traders who fail to comply with the established standard. No sanction schedule would be approved by the commission if it did not provide for the withdrawal of dual trading privileges for any individual who repeatedly fails to meet the standard. The CFTC would then be expected to concentrate its oversight of the exchange's audit trail programs and would be empowered to sanction exchanges for their ^ to effectively enforce these provisions.

Failure

STATEMENT OF ROBERT ISAACSON*, VICE PRESIDENT NATIONAL ASSOCIATION OF FUTURES TRADING ADVISORS

Good afternoon Mr. Chairman and members of the Subcommittee. I am Robert Isaacson, an independent commodity Trading Advisor from San Francisco, California. I am here today as Vice President of the National Association of Futures Trading Advisors, known as NAFTA. NAFTA is a national trade association of approximately 150 companies and individuals who manage almost $6 billion in investments for their clients. Our members are commodity trading advisors and commodity pool operators. They operate or advise a substantial number of the commodity pools and managed accounts currently in existence.

Managed accounts and commodity pools provide an increasingly popular alternative to direct speculative trading by individual investors. Accordingly, NAFTA's members are substantial users of the exchanges on behalf of their customers. As you can see, Mr. Chairman, investor confidence in the U.S. futures markets is essential to the continued vitality and growth of our industry.

NAFTA welcomes this opportunity to share with the Committee the experience of its members under the current regulatory framework and to provide views on several of the issues raised in H.R. 2869. Our comments address three areas: 1) permanent reauthorization of the CFTC; 2) specific issues of concern to futures investment managers; and 3) more general points raised in the legislation.

First, Mr. Chairman, NAFTA enthusiastically supports the proposal for permanent authorization of the CFTC. In previous testimony before this Committee, NAFTA has supported measures to extend the reauthorization period for the CFTC. We commend you for your suggestion to place the CFTC on the same permanent footing as other federal agencies with similar responsibilities in regulating financial markets. The history of the CFTC since its creation in 1974 indicates a steady growth in staff expertise and sophistication. The growth in the volume or trading on U.S. exchanges during this period indicates increasing confidence in these markets, in part because of the regulatory framework which distinguishes our markets from many foreign competitors.

We believe the periodic reauthorization process drains substantial CFTC staff resources and thereby detracts from the agency's ability to perform its regulatory functions. The benefits of the the reauthorization process could, in our opinion, be achieved more efficiently through periodic oversight hearings. In addition, of course, the ability of Congress to conduct investigations and hearings on specific topics of public importance, such as the recent investigation of futures trade practices, would not be impaired.

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* Principal, Commodity Investment Consultants, Inc., Menlo Park, California

Our second area involves the unique niche in the futures industry occupied by NAFTA members. NAFTA members organize and operate commodity pools, and manage both pool and individual accounts. Commodity pools resemble investment companies, while the services rendered by commodity trading advisors substantially resemble those of investment advisors in the securities industry. To the extent practicable, similar regulatory frameworks should apply to both the futures and securities industries, so that neither set of investment managers receives a competitive advantage as a result of disparities in the manner in which they are regulated.

This issue is particularly acute for NAFTA's members in the area of publicly offered commodity pools. These pools trade in futures contracts and are subject to CFTC jurisdiction. They are typically offered in the form of limited partnerships, however. Therefore, the SEC and state securities agencies also regulate pools, since the limited partnership interest constitutes a security. Consequently, a publicly offered commodity pool must satisfy the regulations of the CFTC, SEC and of the states in which the particular offering is to be made.

One highly unfortunate result of multiple regulation has been a steady increase in the size of prospectuses for publicly offered funds and subsequent corresponding increases in the costs of organizing such funds. NAFTA's members believe that the length and complexity of disclosure is now so great that, in some cases, investors are literally overwhelmed with information. This completely defeats the very purpose of disclosure. For these reasons, NAFTA supports and commends the recent increase in communication between the financial market regulators, as evidenced by recent companion releases on the subject of disclosures related to publicly offered commodity pools.

NAFTA urges both the CFTC and SEC, for example, to explore the possibility of a two part prospectus requirement for publicly offered commodity pools in the manner currently permitted by the SEC for investment companies. NAFTA believes a simplified prospectus could make disclosures to prospective commodity pool investors more meaningful, while a more detailed supporting prospectus (comparable to what is now required to be provided to all investors) could be made available on request to those investors who desire additional information. NAFTA suggests the Committee urge the CFTC to examine this area with a view to proposing streamlined and simplified disclosures for publicly offered commodity pools. This is an area in which NAFTA believes there should be greater parity between competing pooled investment vehicles.

Another area of particular concern to NAFTA's members is that of speculative position limits and aggregation policies. These policies were initially promulgated prior to the development of a managed money sector in the futures industry. And they have not been reconsidered for their impact in inhibiting the development of the managed money products. NAFTA is aware several large and extremely successful commodity trading advisors have increasingly turned to allocating funds to foreign markets in order to avoid restrictions imposed by speculative position limits which apply to U.S. markets but not to foreign markets. As capital flees U.S. markets to less regulated foreign markets the consequences for the public and for the futures industry itself become increasingly negative. Potential investors could be harmed because foreign markets typically have substantially fewer customer safeguards. While no one believes U.S. markets should compete with foreign markets by eliminating what are widely recognized to be valuable customer protection measures, NAFTA believes speculative position limits and aggregation policies should be reviewed thoroughly for their continued efficacy. NAFTA requests Congress to encourage the CFTC to continue the work it began in this area when it recently modified some of its rules pertaining to aggregation.

Turning to specific provisions of H.R. 2869, NAFTA does not believe a prohibition of dual trading is appropriate or necessary at this time. While NAFTA appreciates that unspecified alleged abuses have prompted the proposals to prohibit dual trading, we believe substantial and valid reasons call for better remedial steps. First, the proposal would have several negative consequences:

(1) Many of the most skillful brokers may choose to trade entirely for themselves and no longer for customers. Because many money managers execute large orders for their clients, quality execution of trades is particularly important. Many NAFTA members devote substantial attention to reviewing the quality of order fills and selecting the brokers with whom they place orders. If a ban on dual trading were to convert brokers into traders, the ability of our members to trade profitably for their customers would be hampered.

(2) Such a ban would reduce the liquidity of the markets. In some cases, this would make it more difficult to enter and to exit positions for customers; and

(3) If for any reason volume were to decrease significantly, a dual trading ban would result in increases in brokerage commission rates.

NAFTA believes dual trading should be allowed to continue, subject to disclosure to customers that a broker intends to trade for his own account Existing CFTC regulations require just such disclosure to prospective customers of commodity trading advisors and commodity pool operators. This disclosure would allow a customer to choose for himself without the market having to suffer the costs I have just described.

Furthermore, we believe increased surveillance by the exchanges and by the CFTC, along with technological developments enhancing the quality of audit trails, should make all trade practice abuses increasingly rare. NAFTA believes a prohibition of dual trading should not be implemented until intermediate alternative steps have been tested. The effects of a dual trading ban on market liquidity needs to be evaluated.

H.R. 2869 would require exchange and other self-regulatory organization governing boards to include at least 20 percent "non-member" directors. NAFTA supports the concept of outside directors on governing boards as a general principle. In fact, the NAFTA board of directors includes an outside director,even though we are a private trade association. However, NAFTA believes no particular merit exists in a fixed 20 percent requirement. NAFTA believes the experience and knowledge of individual governing board members, whether member or non-member, are more critical to sound decision-making and representation of public interests than mandated percentages.

H.R. 2869 would impose a three-day "cooling off" period between the time an account is opened for a first-time speculative customer who was solicited by telephone and the day on which this customer may make his first trade. First, I would point out that telemarketing is not used to any significant degree by NAFTA members. Nevertheless, in the interests of enhanced investor confidence in our markets, we support the concept of such a cooling-off period. NAFTA members are concerned, however, that it would be extremely difficult to implement and police the proposal contained in H.R. 2869. For example, it is not clear to what extent a brokerage firm could rely upon oral assurances from the customer that he was not a first-time customer. What types of evidence would suffice to permit a broker to satisfy this question?

Finally, NAFTA has long supported the development of ethical standards throughout the futures industry. In fact, NAFTA views as one of its purposes the enhancement of ethical standards for trading advisors and pool operators and intends to include sessions in this area in its future annual meetings.

Our segment of the futures industry is subject to a broad array of regulation. Commodity trading advisors, commodity pool operators, and their associated persons are required to register with the NFA. Each of these associated persons must first successfully pass the National Commodity Futures Examination. The NFA conducts regular audits of all NAFTA members. Exhaustive disclosure, recordkeeping and reporting regulations govern commodity trading advisors and pool operators, and pool operators must provide annual audited financial statements to their customers, the NFA and the CFTC.

These regulations have been in place for over a decade, and continue to be supplemented from time to time by NFA compliance rules covering areas such as promotional materials. NFA staff also conduct periodic compliance audits. Comprehensive securities regulations also govern pool operators and trading advisors.

NAFTA members are thus subject to a very broad range of compliance responsibilities. This regulatory framework is considerably broader in scope than that applicable to almost any other CFTC registrants.

All of this leads NAFTA members to believe more vigorous enforcement of existing futures industry regulations may be more effective in preventing abuses than another regulatory layer of "ethics" training. This is in large part due to NAFTA's concern that serious problems must be very carefully considered in developing any regulations to implement such a requirement. Would this requirement create a financial hardship on individuals and smaller firms, for example, by imposing travel to central locations for initial or refresher training sessions? For these kinds of reasons, NAFTA urges extreme care in crafting any regulations' and we commit our full assistance to the CFTC for that purpose. In fact, NAFTA would undertake to provide any such required training for its members and would encourage Congress to suggest such an approach for members of NAFTA and other similar trade associations.

Mr. Chairman, we appreciate the opportunity to present the views of our Association. I will be happy to answer any questions you may have.

NATIONAL ASSOCIATION OF FUTURES TRADING ADVISORS

July 21, 1989

The Honorable Glenn English
Chairman
Subcommittee on Conservation, Credit,
and Rural Development
Committee on Agriculture
U.S. House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

Thank you again for the opportunity to testify before your Subcommittee this week on H.R. 2869. I listened carefully to the other witnesses throughout the day, and also to the question and answer exchanges between the Members and the witnesses. As I reflected on all of them, I began to think of things I wished I would have added to some of my own answers to your questions.

It was most clear to me that you and your colleagues are thoughtfully seeking to raise the professional and ethical standards applicable to futures industry participants, and to do so without harming the quality of the critical services provided by the markets. On behalf of an industry of commodity trading advisors and commodity pool operators whose economic well-being depends upon investor confidence in these markets, I want to reemphasize my appreciation for the way in which you are approaching this task.

I hope it is not presumptious of me to ask to supplement my message to you, but I am very troubled by what was not well said by me, or frankly, any of the other witnesses. Looking back, the repetitive concerns expressed about the dual-trading provisions of H.R. 2869 may have failed to communicate fully to the Subcommittee why the potential harm which could result from the proposed ban poses such dangerous risks to precisely what the Subcommittee seeks to improve.

I know, Mr. Chairman, you and Mr. Coleman have sought to mitigate these risks by providing flexibility in the imposition of the dual trading ban. These efforts are your own acknowledgment that dual trading can and does make significant contributions to the efficiency and economic utility of the markets -- contributions to be fostered and protected. Believe me, NAFTA members appreciate that sensitivity.

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But we remain very nervous, Mr. Chairman, over the fact that none of us, whether congressman or exchange member, CFTC economist or money manager, is able to quantify the potential cost of banning dual trading in a given market. That the CFTC would have the authority to lift the ban, if and when economic damage to the contract later appeared, would not really help; the damage would have been done. In the same vein, that a given customer might personally authorize his own broker to dual trade still tells us nothing about the liquidity impact of a ban on that particular market, other than logically it should be somewhat less than it might have been otherwise. Nevertheless, what would be the costs -- with or without the variables and the flexibility? We just don't know, and indeed perhaps we never could know until they had actually been incurred.

Against that scenario, what benefits might flow from the proposed ban? We think it it would be an illusory curtailment of the opportunity for an unscrupulous floor broker to trade ahead of his customer. We think it would be illusory because, frankly, the broker bent on cheating his customer can no longer safely do so on his own. Even the worst of the current exchange surveillance systems is able to detect this crude form of frontrunning. To the extent it is in the markets, and we do not suggest otherwise, frontrunning is much more sophisticated. For starters, it involves an accommodating broker. Of course, a ban on dual trading would in no way affect this kind of customer abuse.

NAFTA, therefore, would prefer to see a real heightening of the standard: something which could actually benefit the vulnerable public customer orders. To do so, we would urge you to do with floor brokerage standards what H.R. 2869 would do with the exchange audit trail requirements -- codify the existing CFTC regulations which prohibit not only trading ahead, but disclosing orders, prearranging trades, allocating winning and losing positions after the fact, and so forth.

Part 155 of the CFTC's regulations now requires exchanges to adopt and enforce such prohibitions. By codifying these specific trade practice standards, anyone violating them would transgress specific federal law in addition to individual exchange rules. (We do not share the concern that codification of a dual trading prohibition may somehow compromise ongoing Justice Department activities, since dual trading constitutes fraud which is punishable as a felony under the present terms of the Commodity Exchange Act.)

This would not only make such trade practice violators easier targets for federal law enforcement officials, but would also enable aggrieved customers to avail themselves directly of the Act's private right of action authority. Customers could do so without having to undertake the indirect (and more legally complicated) challenge of a particular trade practice abuse constituting civil fraud under Section 4b of the Act.

Such an amendment to H.R. 2869 would do much more to heighten industry standards than would the bill's current Section 101. It would put teeth into the Act instead of hope. It would raise the standards by raising the cost of violating them. And it would be much more consistent with the goals you and your colleagues have announced than would the ban on dual trading.

Should you wish to pursue this matter, NAFTA's Executive Director, Bill Seale, will be available to do so on our behalf. In the meantime, Mr. Chairman, thank you again for the opportunity to appear before your Subcommittee this week.

Sincerely yours,

Robert Isaacson

Robert Isaacson

cc: The Honorable E. Thomas Coleman

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COMMODITY FUTURES IMPROVEMENTS ACT OF 1989

THURSDAY, JULY 20, 1989

House of Representatives,
Subcommittee on Conservation,
Credit, and Rural Development,
Committee of Agriculture,
Washington, DC.

The subcommittee met, pursuant to notice, at 10:10 a.m. in room 1300, Longworth House Office Building, Hon. Glenn English (chairman of the subcommittee) presiding.

Present: Representatives Tallon, Penny, Nagle, Harris, Staggers, Sarpalius, Long, Coleman, Morrison, Gunderson, Combest, Grandy, and Holloway.

Also present: Representative E (Kika) de la Garza, chairman of the committee, and Representatives Huckaby, Glickman, and Jontz, members of the committee.

Staff present: Fred J. Clark, associate counsel; William E. O'Conner, Jr., assistant minority staff director; John E. Hogan, minority counsel; Alice Devine, minority associate counsel; Glenda L. Temple, clerk; Bill Cherry, James E. McDonald, James A. Davis, Thomas H. Lederer, and David Ebersole.

OPENING STATEMENT OF HON. GLENN ENGLISH, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF OKLAHOMA

Mr. English. The committee will come to order.

This is the second day of hearings of the Commodity Futures Improvements Act of 1989. Tuesday's witness list included a wide spectrum of the futures industry but today's list is even wider. It includes a farmer, a floor broker, and representatives of most other parts of the industry. We will change the order of today's witnesses. Late yesterday, officials from the Chicago Board of Trade notified us that Mr. Mahlmann could answer questions about the emergency order involving July soybeans if he could appear after trading in the contract ends in Chicago. Trading ends at noon Chicago time or 1 p.m. here. I know that many members of the subcommittee want to get complete answers instead of the answers they got on Tuesday. So I changed the schedule of witnesses. Mr. Mahlmann will appear this afternoon.

To help members of the subcommittee, we obtained the cash soybean prices from the Agricultural Marketing Service at USDA and arranged them in a table that includes the settlement price at the Chicago Board of Trade. This is included in the material in front of the members. I look forward to hearing today's witnesses.

[The information follows:]

CBT July Settlement and High Cash Market Prices of Soybeans for Selected 1989 Dates (Dollars per Bushel)

1989:	CBT July Settle	Chicago 15 day	Toledo	Minn.	Illinois Process.	Memphis	Kansas City
6/30	7.3500	7.3500	7.3850	7.1450	7.4700	7.3600	7.2500
7/03	7.4050	7.4050	7.4350	7.2050	7.6200	7.4000	7.4650
7/05	7.7650	7.7650	7.7350	7.4850	7.8400	7.7400	7.7200
7/06	7.6500	7.6500	7.6350	7.3750	7.7500	7.6200	7.5900
7/07	7.6650	7.6650	7.6100	7.3600	7.6900	7.6400	7.4500
7/10	7.4350	7.4375	7.3850	7.1050	7.3350	7.3700	7.1300
7/11	7.2600	7.2600	7.2100	6.9450	7.2900	7.2500	7.1000
7/12	6.8650	6.8650	6.7850	6.6350	6.9450	6.7900	6.4300
7/13	6.9750	6.9750	6.9200	6.8100	7.0000	6.9700	7.0500
7/14	7.0350	7.0350	6.9550	6.9525	7.0850	7.1000	7.1300
7/17	6.7750	6.8000	6.7450	6.6725	6.8350	6.8400	6.8350
7/18	6.9550	6.9550	6.9350	6.8200	6.9200	6.9800	6.8400

Mr. **English**. Now, Mr. Coleman, for any opening remarks.

Mr. **Coleman**. I have no statement.

Mr. **English**. Mr. Tallon.

Mr. **Tallon**. I have nothing, Mr. Chairman.

Mr. **English**. Mr. Combest.

Mr. **Combest**. Nothing, Mr. Chairman.

Mr. **English**. Our first witness today is Mr. Robert D. Josserand, who is president of the National Cattlemen's Association.

Mr. Josserand, if you will come to the witness table we will be happy to receive your testimony. Let me also say that, Mr. Josserand, you and all of our other witnesses today, if you would care to summarize your written testimony, please feel free to do so, and your complete written testimony will be made a part of the record.

STATEMENT OF ROBERT D. JOSSERAND, PRESIDENT, NATIONAL CATTLEMEN'S ASSOCIATION, ACCOMPANIED BY ALAN SOBBA, DIRECTOR, TAX AND CREDIT

Mr. **Josserand**. Thank you, Mr. Chairman.

As you have said, I am Bob Josserand from Herford, TX. I am a cattle feeder; however, I am here today representing the National Cattlemen's Association. I want you, Mr. Chairman, and the subcommittee to know how much we appreciate the opportunity to express our views on this very critical issue as far as the cattle industry is concerned.

I want to say right up front that our primary working relationship is with the CME. Several years ago, we started a cooperative venture in which our cattlemen were extremely concerned about some of the attitudes toward the CME and some of the things that were happening, and we started a joint project with them that has been very successful, I think. We continue to work with them. We think we have made some significant improvements. I would like also to thank the committee for moving in such a timely manner on House bill 2869.

I am going to be very brief, Mr. Chairman, and I will be very happy to answer any questions the committee might have afterwards. I am going to attempt to summarize. I am going to follow the bill's titles. Title I, limitation on certain trading practices—dual trading. Very simply, the National Cattlemen's Association supports the elimination of dual trading. We do not think under the present monitoring system available on the floor that dual trading is supportable by the exchange and simply because the pit brokers' cards are submitted every 30 minutes and there is absolutely no way to successfully monitor and audit trading.

We would also recommend, Mr. Chairman, that the elimination of dual trading simply be across the board on all commodities. I don't think it's feasible to eliminate dual trading in some pits and not all. We would also like to suggest that the elimination of dual trading would probably do more to restore confidence by the cattle industry in the futures market.

We would also like to support membership disclosure and elimination of dual trading for individual traders in banning members of brokers' associations from trading for their personal accounts in all exchange markets against orders executed by members of the same broker association, regardless of profit-sharing arrangements. Allowing dual trading to continue within broker groups but prohibiting it by individual traders is not fair and would put several people at competitive disadvantage.

Title II, the enhancement of regulatory and enforcement activity—audit trails. One of the great concerns, Mr. Chairman, of our industry is the audit trail. And we do not think today, given the fact that pit broker cards are bracketed into 30-minute segments that the exchange can narrow the audit trail to make it meaningful. We would like to recommend that increased audit procedures to cross-match information on a pit broker's card with the brokerage house, outside orders, be mandatory.

NCA also recommends increased research into the use of hand-held electronic recording devices or other emerging technology to record pit brokers' transactions in lieu of the traditional hand-held pit broker cards. We also support the concept of separate time brackets for market openings and closings. We feel that there is too wide a trading range at the present time and we would like to see a definite time bracket.

Closer and more frequent monitoring of positions held by registered commercial traders is recommended to assure that these positions are in fact bona fide hedged positions. Auditing procedures may be required to establish that the commercial trader in fact has product or orders in the physical market that are being offset by hedged positions in the futures market.

The National Cattlemen's Association has been working quite closely with CFTC Chairman Wendy Gramm; has urged their complete and full cooperation with the ongoing FBI investigation. We continue to participate and cooperate wherever possible so that the public confidence in the integrity of the futures market is maintained.

The National Cattlemen's Association supports the concept of self-regulation by the futures industry with continued strong oversight by CFTC. We feel that if the exchanges themselves will adhere to the penalties as proposed by the exchanges and will continue to monitor their own activities, with oversight by CFTC, that it would be much stronger than additional people, additional regulators from CFTC on the floor or in the pits. Strengthening self-discipline committees will help restore integrity to the market. We would also urge that greater representation by nonfloor membership is a necessary step. One item that we would like to see handled in your bill, if possible, is the fact that we do require registration of floor traders, or require some type of activity which will give cattlemen and others increased confidence in floor brokers.

We also think that tied with the registration of floor traders should be enhancement of registration requirements. We are not sure that we totally have the kind of background checks and education required for brokers. The concept of self-regulation with strong CFTC oversight is supported by NCA. Without strict enforcement of penalties, regulations lack the teeth to insure compliance with self-imposed rules.

The integrity of self-regulation is directly tied to ethical standards. We would urge the committee to make sure that extensive ethical training would be established both for the exchanges and the floor brokers. We would like to share just a few other comments with you, Mr. Chairman.

We would recommend and support permanent authorization of CFTC. We feel that this is long overdue. It would allow the Commission to redirect some of the funds and staff that presently is expended to repair for reauthorization and would allow that staff and funds to be directed towards its primary function.

We think that adequate numbers of highly trained, qualified, experienced personnel are central to the accomplishment of any mission. NCA supports CFTC's request for increased personnel and funding, which have been outstripped by growth in the futures industry during the recent years. One specific issue, periodic verification of positions held by commercial traders as bona fide hedges is the type of information that increased surveillance could create and should create.

The use of electronic systems in place of open outcry offers unlimited advantages in recordkeeping, market surveillance, ease of use, and opens opportunities for additional refinements. NCA strongly encourages the exchange to implement electronic trading systems during normal trading hours as an alternative to open outcry.

We think that, while this is a long process and we appreciate your efforts, we think that what you are doing will restore market integrity in light of the recent investigation by establishing CFTC as the futures regulatory agency, you will serve very much the people in the country.

Mr. Chairman, National Cattlemen is certainly willing to assist you in any way that we can in this endeavor and I would be happy to answer any questions should there be some.

Thank you.

[The prepared statement of Mr. Josserand appears at the conclusion of the hearing.]

Mr. ENGLISH. Thank you very much, Mr. Josserand. I appreciate that.

Let me ask you with regard to the state of confidence in the futures markets as far as the cattlemen of this country are concerned, members of your association. Do they have a high level of confidence in the integrity of the market as it stands today?

Mr. JOSSERAND. Mr. Chairman, I would have to say that certainly the opinions are split. If you asked me for a percentage, I would say probably half of our members do have that confidence; half have some concern, particularly those who do not use the futures as a price risk protection mechanism, those who—I do not want this to sound wrong—but those who are in rural areas that just simply do not have adequate communication on a daily basis; I think those people have some concern about the integrity of the market.

Mr. ENGLISH. We heard a great deal of concern expressed, of course, from the industry itself shortly after it was announced in January that there had been a probe by the Justice Department, that an undercover operation had been under way for several months; and we seemed to find a great deal of interest within the industry in trying to address any problems pertaining to questions of the integrity of the market, to be willing to tighten up. As time has gone by and no one has been prosecuted; that seems to be lessening. Does that change anything, the fact that no one has been indicted and prosecuted to date? Does that change the need, in your opinion, for addressing the question of integrity?

Mr. **Josserand**. Absolutely not, Mr. Chairman. In fact, I think it intensifies that need from the standpoint that in the country, the general feeling is, you know, the investigation was announced, that there would be indictments forthcoming and, as you say, nothing has occurred. I think the country is saying why, when, and what are we going to do about it; and I think if anything it intensifies the efforts on your part.

Mr. **English**. Mr. Coleman.

Mr. **Coleman**. Well, Mr. Josserand, your organization and the Chicago Mercantile Exchange have entered into some advisory capacity; there's an advisory board and so forth. Would you tell us a little bit about the ongoing relationship that you all have set up and how do you think those are proceeding?

Mr. **Josserand**. Yes, sir, Mr. Coleman. We have had in the past 2 years a very good working relationship with the Chicago Mercantile Exchange in that our members asked 3 years ago for a task force to be appointed out of the National Cattlemen to really take a look at the cattle futures and what they meant to the industry; and within the framework of that task force and in the framework of the recommendations that came out of that task force, we feel like we have been at least partially responsible for some significant changes in the cattle futures; we feel like that we have had some input and we do have nonvoting members serving on the live cattle committee and the advisory committee; we do feel like we've had a considerable amount of input into some significant changes, important changes as far as we were concerned. We have not gotten all of the things that we thought would make the cattle futures a better tool for us, items such as cash settlement, which we would still like to see.

We also realize the difficulty in the use of cash settlements because of our pricing situation within the entire industry. We still feel that that is a viable option down the road, but we also realize that the industry has to solve its own price discovery system.

Our relationship with the Merc, I submit to you, is very good; they have been very cooperative; we've worked with them. We still have some changes we would like to see made, but I think that's possible, and I think they are open to input from the cattlemen.

Mr. **Coleman**. Well, I thank you.

Mr. **English**. Mr. Tallon.

Mr. **Tallon**. Mr. Chairman, thank you, and Mr. Josserand, thank you for your testimony.

In looking back over it, of course, we heard you testify that you support elimination of dual trading, period. Of course, the legislation, the bill that has been introduced provides for dual trading under certain circumstances. How would you feel if we included in this legislation criminal penalties, if we provided for criminal penalties within the legislation for a trader that was trading ahead of the customer? Do you feel like that should be included in the legislation?

Mr. JOSSERAND. I think, Mr. Tallon, if you asked our members, the integrity of the exchanges is foremost and I think that our membership would have no problem with that type of activity.

Mr. TALLON. Thank you.

You seem to indicate the problem that you have with dual trading is with the way the audit trail is reconstructed. At the present time, is there a possibility that with a tighter audit trail, a more efficient audit trail that you could be confident with dual trading? What kind of changes would you recommend?

Mr. JOSSERAND. I think No. 1 is that we do have to tighten up the audit trail. I think our concern is simply the integrity when we have dual trading and under present circumstances, I guess our best option is the total elimination of dual trading. If, in fact, we were comfortable and the country was comfortable with the audit trail, then I think we might reconsider that.

Mr. TALLON. I think you said that maybe half of your members had a problem with dual trading, and maybe the other half did not, and that probably the half that did not were people who didn't use the market on an ongoing basis and maybe were not as close to the market and maybe didn't communicate or have the means of communicating with the markets?

Mr. JOSSERAND. Mr. Tallon, what I think I said or hope I said was that with regard to the futures market, about half of our members had real questions about the use of them. I think as far as the dual trading goes, you could say almost 100 percent of our membership would recommend the elimination of dual trading under present auditing procedures.

Mr. TALLON. And so the recommendation certainly would extend to a ban on all dual trading, regardless of the amount of volume in contracts, no concern for liquidity; I mean, we just ought to ban dual trading across the board?

Mr. JOSSERAND. Mr. Tallon, we are very sympathetic to what the ban on dual trading would do to liquidity in a particular contract. We realize that there possibly can be some serious repercussions. However, we think if we do not get the elimination of dual trading, the repercussions from the questioning of the exchange and the futures contract greatly outweigh the lost liquidity.

Mr. TALLON. Of course, we all understand there is nothing wrong per se with dual trading; it's trading ahead of the customer, trading your own order before the customer's order, that's the real problem here, and in my mind, another concern that I have that we've heard really very little about is when a futures merchant gets an order, before it ever gets to the floor of the exchange, we are very limited in how we monitor what happens to that order or those orders, or those bundles of orders.

Has the National Cattlemen's Association looked at that and do you have concerns about how those orders are handled?

Mr. JOSSERAND. I'm sure that our task force, working with the CME, did look at that, Mr. Tallon, but I am not knowledgeable about that.

Mr. TALLON. Well, you understand that you can ban dual trading on the floor, but there are so many things that can happen prior to that order ever getting to the floor; and I just have to question if maybe we can't see the forest for the trees.

Thank you.

Mr. **Josserand.** Thank you, sir.

Mr. **English.** Mr. Combest.

Mr. **Combest.** Thank you, Mr. Chairman.

Mr. Chairman, Mr. Josserand is a constituent of mine and only at the last moment yesterday did he find out he would be delivering this testimony. I know how anxious he is, as soon as he leaves here, to get back to West Texas, and from a personal experience of both of us loving West Texas, far be it from me to be the one that would keep him from it. I have no questions. Bob, it was good to see you.

Mr. **Josserand.** Thank you, Mr. Congressman.

Mr. **English.** Ms. Long.

Ms. **Long.** Thank you, Mr. Chairman.

It's nice to have you here today.

You have been talking about liquidity and dual trading and I think that I am sensing from your—you haven't said this specifically—that the dual trading leads to liquidity, which leads to greater market volatility, because you have people buying commodities that you have no real use for in your case, cattle, their buying cattle to resell and that's in a sense playing with the true forces of the market. Is that what you are saying?

Mr. **Josserand.** Well, I think our concern about dual trading is one of fairness, one of the integrity of the market. I guess if you looked at the cattlemen in general, there are those who do have that concern about people trading in any futures market without need of the product; but at this point in time, a discussion on dual trading I think is one of fairness and is one of perception as much as anything that things are being handled correctly and right and that there is not misuse of the ability to dual trade.

I think more than anything I have to say that with the confidence in the system, I think it's perception more than anything else.

Ms. **Long.** Let me ask you another question along those same lines. We tend to assume that liquidity is in and of itself good because it can keep a market active. Are you suggesting that liquidity has some negative aspects, that liquidity that results from demand from buyers who have no real use for the commodity that that is not necessarily good for the market?

Mr. **Josserand.** Ms. Long, I am not trying to say one way or the other.

I think as far as the position of the National Cattlemen, we certainly would encourage all of the liquidity we could get into a market, even though we realize that it can cause some wild price fluctuations once in a while. I think if you analyzed our membership and particularly that segment which probably are not familiar with the futures, you would find that they would be quite consistent with the idea that maybe there is too much liquidity once in a while.

Ms. **Long.** Thank you. I'm trying to, the same as you, I think, assess the value of liquidity in the marketplace and am glad to have your input. Thank you.

Mr. **Josserand.** Thank you.

Mr. **English.** Mr. Harris.

Mr. **Harris**. Thank you, Mr. Chairman.

One of the complaints or observations that I've had expressed to me concerning the ban of dual trading is that this would drive the markets overseas, and I just wondered if you have any thoughts on that?

Mr. **Josserand**. No, sir.

Mr. **Harris**. Because we certainly don't want to send any more jobs overseas than we have already seen go. We would like to get some back.

Mr. **Josserand**. No, sir, I do not have any thoughts on that, and I'm sure it has been looked at by our task force. I simply cannot answer that. I do not know.

Mr. **Harris**. You would agree with me that that is a concern?

Mr. **Josserand**. I would agree with you that we don't need to transfer a lot more of our business overseas; yes, sir.

Mr. **Harris**. That's all I have, Mr. Chairman. It's good to see you again.

Mr. **English**. Thank you very much, Mr. Harris.

Mr. Josserand, we appreciate your testimony very much.

Mr. **Josserand**. Thank you, Mr. Chairman.

Mr. **English**. Did you have a question, Mr. Coleman?

Mr. **Coleman**. If I might just make a comment as a followup to my colleague's question, on the other hand, if dual trading were prohibited under certain circumstances, the integrity of the markets in this country would be unquestioned, any problems that might result from dual trading could be caught in a proper audit trail under our proposal. When they exist for higher traded volume, just the opposite probably would occur, would it not? The people who want to buy and sell cattle would want to come to the United States, to make sure that they knew they were getting the proper price and that there was no one taking advantage of their position and so forth. So I would suggest that the bill and the thrust of the bill would be very supportive of trying to retain and enhance our markets as opposed to somehow driving your membership, for example, away from our markets.

Mr. **Josserand**. I think you are right, Mr. Coleman. I cannot perceive of it happening any other way.

Mr. **Coleman**. Thank you.

Mr. **English**. Thank you very much.

Mr. Josserand, we appreciate your testimony.

Mr. **Josserand**. Thank you, Mr. Chairman.

Mr. **English**. Our next witness is Mr. Leo Melamed, who is chairman of the executive committee and special counsel to the board, Chicago Mercantile Exchange in Chicago, and I believe he is going to be accompanied by Mr. William Brodsky, president and chief executive officer, and I believe Mr. Jerrold Salzman will also, outside counsel, will be accompanying him as well.

Leo, we want to welcome you here today and we appreciate you coming down and testifying on this legislation. We are looking forward to hearing your views.

STATEMENT OF LEO MELAMED, CHAIRMAN OF THE EXECUTIVE COMMITTEE AND SPECIAL COUNSEL TO THE BOARD, CHICAGO MERCANTILE EXCHANGE, ACCOMPANIED BY WILLIAM J. BRODSKY, PRESIDENT AND CHIEF EXECUTIVE OFFICER, AND JERROLD E. SALZMAN, OUTSIDE COUNSEL

Mr. **Melamed**. Thank you, Mr. Chairman and members of the subcommittee. I am pleased to be here and honored to represent the Chicago Mercantile Exchange. I am here today with our president, Mr. Brodsky, and general counsel, Mr. Salzman.

I have extensive written testimony, Mr. Chairman, that I would like to submit for the record. At this time, I merely would like to make some opening remarks.

Mr. **English**. Without objection, so ordered.

Mr. **Melamed**. Thank you.

Mr. Chairman, I wish to compliment you and the members of this subcommittee on the investigative effort you have undertaken. It is critical to the future of a very important industry. You should recognize that the expeditious and forthright manner in which you conducted the inquiry serves our industry very, very well.

I am pleased that whatever help we were able to give you in the process brought the investigation to a very expeditious point as we sit here today. I suggest that we move forward from here with a legislative result and reauthorization.

I thank you for undertaking this effort in the manner you did.

I would like to offer a little historical overview on the Chicago Mercantile Exchange because sometimes it gets lost in the shuffle. It was on the floor of our exchange some 25 to 27 years ago when this industry expanded in the direction that brought it prominence and importance—financial futures.

Such instruments as futures contracts on foreign currencies, Eurodollars and Treasury-bills were created as a result of inventive genius on the floor of our exchange. Those financial futures later were so successful that they transformed our entire industry. That led to instruments such as U.S. bonds futures, invented at the Chicago Board of Trade and other financial futures contracts the world over. The base of agriculture, which was the reason for these markets in the first instance—and still is today—was expanded into finance. It became so coveted an idea that every financial center in the world today would like a piece of that action that American genius invented. We are very proud of that, as you are.

After the 1987 stock market crash, there was a cry in the financial community that perhaps our futures markets might have been a factor in that crash. And when we testified before Congress on this issue, we urged Congress not to do anything that might injure this American resource. We cautioned that if they did, the American financial fabric could be hurt in the process.

Indeed, there were those who wanted to wrest jurisdiction from the Agriculture Committee and place it elsewhere. And we testified and urged the Congress not to do so.

We were right. Today's hearing is evidence of our view, because this committee has the expertise, the knowledge, the history of the importance of our markets in the national economy.

So, as we come before you today, I present that bit of history. I am proud to be here and to be with you in an effort to make our markets better, to serve not just the national interest but the world interest. We are a world market today, and everyone comes to our doorstep. We want to provide liquid and efficient markets so that no other markets in the world can wrest this American invention away from us.

I thank you, Mr. Chairman, for these brief opening remarks. I am prepared to answer any questions you have.

[The prepared statement of Mr. Melamed appears at the conclusion of the hearing.]

Mr. ENGLISH. Thank you very much, Mr. Melamed, and I appreciate your statement. I want to recognize the chairman of the full committee, Chairman de la Garza, who has joined us.

Mr. Chairman, do you have any comments that you would care to make, or would you care to lead us off in the questioning?

REMARKS OF HON. E (KIKA) de la GARZA, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF TEXAS

The CHAIRMAN. Mr. Chairman, just very briefly, I want to commend you and members of the subcommittee for the very efficient, practical, and fair way that you have conducted the hearings on the reauthorization of the CFTC and all of the other issues that are before you.

I want to very much extend my appreciation to the industry for the manner in which they have cooperated with us without exception, all segments of the industry. Your responsibility is to those that you serve. We appreciate that. Our responsibility is to those that we serve, including you and those you serve. So, we have a mutual interest in seeing that the industry works hand-in-hand with us for the farmers and all that benefit from what you do.

I wish to thank the industry for the excellent way they have cooperated with us. I will leave the time for questions to the rest of the members of the subcommittee, Mr. Chairman.

Thank you very much.

Mr. ENGLISH. Thank you, Mr. Chairman. We appreciate it very much.

Let me say, as we begin the questions, Leo, I do not suppose there is anyone in the industry that is regarded with more respect as far as being a leader in innovation and a leader as far as the best interest of the futures industry is concerned than you are. I think your reputation is well known.

But I would like to read a little paragraph to you, a paragraph that I know you are very familiar with because in a sense you wear two hats. You wear the hat from the standpoint of doing what is in the best interest of the futures industry and looking to the future as to how we can best approach the problems that the industry may have and, at the same time, you wear the hat of representing the Chicago Mercantile Exchange, and most times those hats coincide and fit together very well.

In this particular instance, the paragraph I want to point out was contained in a report from the Chicago Mercantile Exchange, and this was issued on Wednesday, April 19, of this year. It is a report of the special committee to review the trading practices of the board of governors, and it is signed by a very distinguished group, of course including yourself, people who are highly respected including a former Chairman of the Commodity Futures Trading Commission.

It talks about the issue of dual trading, which I think we have had a great deal of discussion about, and it goes through with regard to the rationale for the position that was taken by this committee.

It states that, while it is valid—the good points for dual trading, it has become painfully evident that the public image of the futures markets and their members has been adversely impacted by the widely held belief that dual trading in the futures leads to customer abuses. All past efforts to explain the rationale for the CME's continued acceptance of dual trading have proved ineffective. Moreover, it has been argued that, as the transaction volume grew, in the CME's major markets the need for dual trading to provide liquidity in those major markets became a less important consideration.

This was the justification for the proposal for a ban on dual trading. And I wanted to point this out because again I think it was a very responsible act. I think that the committee put this together and made an excellent recommendation, and also that the provisions dealing with dual trading contained in the legislation before us here today were in fact modeled after those very recommendations by the CME as is the case with regard to some of the other features. Broker associations, for instance, is almost lifted directly from the Chicago Mercantile Exchange.

So, that along with the fact that in some exchanges, there are some contracts, the Standard and Poor's 500 contract that is traded with CME, already contains a version of a ban. I believe 90 percent of the trades that take place in that contract, dual trading is banned, which is very close to what the estimate is as to what this legislation would be as far as industrywide.

So, I guess that I was struck by the fact, on the one hand, it seems that you are moving in a different direction than this committee reported, which you will remember in which you signed off on, on April 19.

Would it be fair to say today that you are representing the Chicago Mercantile Exchange?

Mr. MELAMED. That is correct.

Mr. ENGLISH. And would it also be fair to say that the statements that were made on April 19 were done by people who were extremely knowledgeable in industry, people who certainly had the best interest of the industry at heart, people who certainly would not take any action whatsoever that would be harmful to the futures industry and what we are looking to forward in the future?

Mr. MELAMED. Absolutely correct.

Mr. ENGLISH. And let me also say that the question of driving business offshore—this has been raised a couple or three times—it would seem to me that the United States, as it stands now, certainly with the exchanges that we have, all the exchanges I am speaking of, and with the regulations, with the systems that we have, the big selling point that the United States has and what is, I think, a strong case that can be made for attracting business to the United States is the fact that we do protect the customer.

He is sure that he is going to be treated fairly, and that that integrity itself is a very, very big selling point. And anything that strengthens that integrity and allows us to point to higher standards, even gives us a better case to be made, as opposed to driving business offshore. Would you agree with that?

Mr. MELAMED. I would agree.

Mr. ENGLISH. Mr. Coleman.

Mr. COLEMAN. I, too, Leo, would thank you and the Merc for your constructive proposals. And I think of all the players in the futures market, you all have responded in a very credible fashion. And as the chairman has indicated, we have based some of our legislation on the concepts and the recommendations of your blue-ribbon committee. At that time, they were only recommendations from your committee, but they seemed to be closing some of the gaps.

I think that you recognize, that the board recognizes that credibility is the issue here, and that we do not want anybody to question the integrity or the credibility of these markets. We do not want to drive people overseas. We want to retain them. We want them to grow and prosper but within a context and framework so everybody knows that what is happening is aboveboard, proper and appropriate.

Having said that, you still differ with us to a certain extent on the dual trading aspect. Your proposal is not exactly identical to the one we have in the bill. And it is based upon an accuracy record of 90 percent, I believe. Once you get to that level and verify that level your proposal would allow dual trading to occur. Is that basically correct, with some exceptions?

Mr. MELAMED. That is right.

Mr. COLEMAN. What is the current accuracy record on your exchange?

Mr. MELAMED. It averages approximately 85 percent exchangewide.

Mr. COLEMAN. And how does that relate to 5 or 10 years ago?

Mr. MELAMED. It is exceedingly better than it was 10 years ago. We did not have a CTR system to measure that accuracy rate. CTR, as you know, is a result of a lot of work between the Chicago Board of Trade and Chicago Mercantile Exchange. It was implemented at the behest of the CFTC about 2 years ago and has been given great credit because no other exchanges in the world—not even the security exchanges—have a system that is as efficient and as up-to-date as CTR.

It can be made better and, obviously, that is our goal.

Mr. COLEMAN. Does the CFTC have a standard that it has given you or goal to reach within a certain period of time?

Mr. MELAMED. I do not know that we are on a set standard. I think 90 percent has been sort of a general goal that the industry and the CFTC would like to strive for.

Mr. COLEMAN. Mr. Salzman, do you want to comment? Do you know the answer to that question?

Mr. SALZMAN. Ninety percent, I believe.

Mr. Coleman. I asked this of Chairman Gramm. The rule the Commission is under is 100 percent accuracy, but nobody has attained that. Is that true? Is that your understanding?

Mr. Melamed. Not my understanding. My understanding is that the goal had been from the inception that about 90 percent was a reasonable level of expectation that would give everyone the comfort level they are trying to achieve; 100 percent is difficult unless your trade is done on a computer.

As you know, we have plans for an after-hours electronic transaction system that would indeed track an audit trail at 100 percent, but that is without human beings. There are no human beings that can effectively do anything at the 100-percent level; but computers can.

In electronic after-hours trading we expect the audit trail to be exactly what you suggest.

Mr. Salzman. I would just like to add, the standard that we are looking at is 90 percent verifiably accurate. That does not mean that we are not 100 percent accurate. It means that there are certain times assigned to trades that cannot be proved through other evidence to be correct.

We think that a very substantial percentage of those trades that are not "verifiably" accurate are accurately timed.

Mr. Coleman. What would be those types of trades?

Mr. Salzman. They would be trades where two or three prices may have occurred within a short period of time, and where we do not have a time stamp on one piece of paper that absolutely shows that the trade was done at time one rather than time two, but we have other reasons to be confident that it was done at time one rather than time two. We do not count that as verifiably accurate.

Mr. Coleman. Now our standard to allow dual trading is pretty well set forth in the exemption which says that an audit trail would have to be capable of detecting any and all trading violations and is fully verifiable. How does that differ from your proposal?

Mr. Melamed. Well, fully verifiable is what I was referring to as a very difficult standard to achieve. While we expect that all systems can do better, no systems will ever be perfect. So, what we are suggesting is that we are going to try to achieve a 90 percent verifiable standard. At that point in time, we will have a comfort level that ought to satisfy all reasonable requests in terms of verifiability.

Mr. Coleman. Can I go on, Mr. Chairman, or do you want to go around again?

Mr. English. I think without question, we are going to go around again because I have some additional questions. I am sure other members will afterward.

Mr. Tallon.

Mr. Tallon. Mr. Chairman, thank you. And, Leo, thank you for your testimony.

I think you said that your accuracy of your audit trail is about 85 percent overall average in all contracts. How long do you think it would take you to reach 90 percent accuracy with the technology? I mean, you would have to spend more money, I would assume, on technology.

Could that be done in 12 months, 15 months?

Mr. MELAMED. Well, I believe we can do it rather quickly. I would not want to label it within a couple of months, nor are we talking in terms of many years. Some time within 1 year it can be done, probably substantially less than 1 year.

The way to do it though is not just to throw money at it. Many of the reforms that were suggested by the Special Committee To Review Trading Practices that Chairman English has made reference to, are the reforms that have to be adopted—the hourly pick up of the trading cards, special brackets at the opening and at the close, lowering the half-hour bracket to a smaller increment of time like 15 minutes.

With few exceptions, the reforms recommended by the special panel have been adopted by our board. These reforms will serve to increase accuracy of the audit trail.

Mr. TALLON. Leo, would the system you have and improvements in the system you have and doing everything you can do, how difficult is it going to be to meet this bill's requirement of detecting any and all of these? Can you do it?

Mr. MELAMED. Any and all, I do not think so. If you had 100 percent verifiability, you would not detect any and all abuses because people are people. I do not know of a system yet devised, in any industry, anywhere in the world that can detect all abuses.

I do not believe our system and the people who work within it are worse than anybody else, but I do not think you can detect 100 percent of anything anywhere.

Mr. COLEMAN. Where is dual trading banned in exchanges that you would be competing with around the world?

Mr. MELAMED. There is hardly any ban on dual trading in the United States or world financial markets. In the securities market there certainly is no ban—the specialists on the New York Stock Exchange are dual traders. The financial manager in cash markets, be it currencies or be it bonds, be it any cash market, is a dual trader.

I dare say that is true in the agricultural industry as well. It is certainly true throughout the world in all the forms and in all the financial centers and all the futures exchanges. Throughout the world there is a form of dual trading. It is not banned.

Now it is not always the same, but it is not banned.

Mr. TALLON. Leo, the specialists on the New York Stock Exchange, those dual traders, how many of them are there?

Mr. MELAMED. Mr. Brodsky.

Mr. BRODSKY. I, of course, cannot speak for the New York Stock Exchange, but basically on the New York Stock Exchange there are about 1,300 members, and I would guess there are probably about 500 members who are engaged full time as specialists. Again, I am giving you an estimate.

Of course, what is significant about the New York Stock Exchange's system is that a specialist has the sole franchise to trade a particular product, where in our markets there is competition between floor traders and among floor traders. So, there are significant differences, but in the particular case of the New York Stock Exchange, the specialist maintains the only public limit order book, and has access to that book, and also has the right to trade for his own account.

Of course, this has been a subject of review by other congressional committees for many decades.

Mr. **Tallon**. And how many traders, how many seats do you all have on the Chicago Mercantile Exchange?

Mr. **Brodsky**. We have approximately 2,700 seats on our exchange. So we have more than double the amount on the New York Stock Exchange.

Mr. **Tallon**. And of those 2,700, do you have any idea how many of those people or what percentage of them are in dual trade?

Mr. **Melamed**. I would say we are talking about in the nature of maybe 33, 40 percent.

Mr. **Tallon**. So 40 percent of 2,700, you have certainly got a lot more specialists.

Mr. **Melamed**. I might be too high. It might be a lot less than that. We have never taken the actual count. So, the range of 40 percent might be far too high. It might be down to, say, 25 percent, in that area.

Mr. **Tallon**. Well, today, if all of a sudden at 11 o'clock this morning, none of those 2,700 floor brokers were allowed to dual trade anymore, what kind of impact do you think it might have on liquidity on your exchange?

Mr. **Melamed**. Well, that is the $64,000 question. I am afraid that it is very difficult to answer except to say it would be dangerous because dual traders provide a form of liquidity in certain pits. Depending on the nature of the market, they provide a mainstay of liquidity. It is not even. I mean there are some markets that need it more than others.

But that is the danger in this delicate balance between the perceived evil that dual trading might represent, which is a perception, and the reality of the liquidity they do provide, which is reality. And in trying to balance the two, we are always very mindful of the fact that if we go too much to one direction, we hurt the other direction. You are talking perception versus reality.

Your question is right on the button, very important. I cannot answer the question but to say that it is a dangerous kind of situation. We must be very careful not to injure whatever liquidity that is provided by those traders.

Mr. **Tallon**. It might even possibly be catastrophic. If nobody were allowed at 11 o'clock this morning to dual trade anymore, the spread could become impossible and there would be no more liquidity.

Mr. **Melamed**. I would not rule that out. That is one of the dangers that we are dealing with absolutely.

Mr. **Tallon**. Thank you. My time has expired, Mr. Chairman.

Mr. **English**. Mr. Combest.

Mr. **Combest**. Thank you, Mr. Chairman.

Mr. Melamed, I need to replow a little ground here, and I apologize to my colleagues if I am the only one that is a little fuzzy on this, but I need to try to make sure I am clear on what you are saying.

In your testimony on page 18, reference to any and all instances of trading violations and the requirements that the audit trail be fully verifiable, you say these are impossible standards. Perfection is not attainable in the futures industry nor in any other. Detection of any and all instances of wrong-doing is an unreasonable standard that can never be met.

Yet, I thought I heard you define that probability of reaching that as very difficult in a question to Mr. Coleman.

Let me make it for sure. Is your testimony that you are saying that detection of any and all and the fully verifiable are impossible, you cannot attain it ever, period? Is that right?

Mr. **Melamed**. In the environment of open outcry, when humans are the element being used to create the transaction, I am saying yes to your question. It is impossible.

If you are talking about the electronic or technological world such as with computers, such as we are also suggesting to create, it is not impossible. In fact, we will attain it.

Mr. **Combest**. It was suggested by someone—and I apologize I cannot recall who; I do not guess it really matters—that that technology is available today.

Mr. **Melamed**. In terms of computers, it is, yes. And we will use it.

Mr. **Combest**. In follow-up to the chairman's initial questioning, I want to be sure I am also clear on this issue, are you saying that you would not be concerned—are you saying that if the bill in its current form passes and becomes law, that you would not be concerned about any loss of business offshore?

Mr. **Melamed**. No, I am not saying that.

If the bill passes in its current form and if we cannot comply with the requirements and the standards set and if, in fact, we have taken away dual trading capability from a large segment of our market participants, I am very much concerned with what will happen to liquidity.

Our competitors are now worldwide as I said in the opening remarks. The Japanese just this June opened a market directly in competition with the inventions of the Chicago Mercantile Exchange. As you know, the Japanese are very competent in what they do.

I am very concerned that they can and will attempt to wrest these markets from us. I am not at all saying that they cannot. Even standing with us toe to toe, without any restrictions on our market, it is going to be a difficult battle as it is. With restrictions that might injure the liquidity base of our markets, then I say one of our hands is going to be tied behind our back. I do not want to go into that kind of fight, and I know Congress would not want us to.

Mr. **Combest**. One of the caveats you said where you would be concerned about loss of business was if we could not comply. If the bill passes in its current form, do you think that it is possible for you to comply with it?

Mr. **Melamed**. Not with 100 percent.

Mr. **Combest**. Thank you.

Mr. **English**. Ms. Long.

Ms. **Long**. Thank you, Mr. Chairman.

I would like to talk a little bit more about liquidity. Liquidity up to a point is good, but liquidity can be so great that it just increases the volatility in a market. We have been operating I think a bit under the assumption that, as long as we have dual trading, we can increase liquidity, and by increasing liquidity we have a more efficient market, a better running market.

I would like to ask you: Do you believe that in the past there has been at different points in time so much liquidity that it has led to greater volatility in the market, and as a consequence problems with tremendous price fluctuations?

Mr. **Melamed**. With all due respect, I know of no study from any academic source that would suggest that liquidity creates volatility. Just the opposite, in fact. Our experience and all academic studies have shown that in markets that have less liquidity, have more volatility. Price gaps develop between the current price and the next price simply because there are not enough bids and offers flowing to that marketplace.

All studies would underscore the fact that liquidity lessons volatility. The more liquidity you have, the thicker the market. The thicker the market, the less volatility. That is not to say that volatility cannot occur for a lot of other factors, and does, but not because of liquidity.

Ms. **Long**. But it can; once you get beyond sort of an optimal point, it can do that. And what I am asking you is: Have you seen that? And apparently from your response you have not seen that in your experience.

Mr. **Melamed**. I have not seen it, nor do I believe the theory is that it would occur beyond a certain point. As a matter of fact, all theory I have seen suggests the opposite. The more liquidity, the thicker the market, the less volatility.

Ms. **Long**. Up to a point, that is absolutely correct up to a point.

Mr. **Melamed**. I have not seen that point nor seen it in theory. I hate to differ with you, but from my reading and my understanding of what the market is, and from practical experience, there is no particular point. It is just simply the more liquid a market, the thicker it is.

As the gentleman who testified on behalf of the NCA, Mr. Josserand, said that as far as he is concerned, the more liquidity, the better. Sometimes the view is that there is something wrong with liquidity. Actually, what that means is more bids and offers and participants in the market.

Ms. **Long**. But it depends upon—the reason you have participation in the market depends upon whether you have speculation that is leading to liquidity, versus you have participation by people who have an actual end use for the commodity. And all of those variables are going to influence how positive liquidity is.

Mr. **Melamed**. The end-user of the market could not survive without the speculator because it is the speculator who takes the risk. The perfect market where there is no speculator, you can find in some places in the world, but they have no market. And you are acquainted with those places.

We need the speculator. The speculator's bids and offers are no different in the marketplace than is the end user's bid and offer. The bid and offer is the same. It is called liquidity.

Ms. **Long**. But, of course, we need the speculator but we need to have some kind of balance between speculation and end use of the commodity, and all of these things have to, in order for the market to be fairly stable, be at some level of balance.

I think that what we are looking for here, and I would assume what you are looking for there, is a means of operating the exchanges so that we are close to that balance most of the time.

I am trying to get from you—I think I am getting a pretty reasonable assessment of where you stand and what you believe—what is a reasonable level of liquidity, how much dual trading contributes to that liquidity so that we can then determine, and I individually can determine, under what circumstances dual trading is in fact useful for the exchanges.

In your assessment, the more liquidity, the better. Is that a fair assessment?

Mr. MELAMED. That is correct.

Ms. LONG. Thank you.

Mr. MELAMED. I do not know other than that what to think because we have both theoretical and practical experience supporting this. As far as the balance between speculation and commercial activity, each market has a different balance. There is no particular rule on that either.

Some markets that I am acquainted with that are very, very successful have as high as a 95 percent factor of commercial activity and only a 5 percent factor of speculative activity. On the other hand, I know of markets that are also very, very successful that have a 70 percent factor of speculative activity and a 30 percent factor of commercial activity, and yet they too are successful. And everything in between those two extremes can find balance and successful markets.

There is no particular rule I know of that can tell us what the optimum balance ought to be. The marketplace is the only one that can determine that, and thank God that we have a system of free markets that allows the marketplace to seek that kind of level.

I will say this. If the correct level is not achieved by the market itself, that market will not exist and it will die, and many markets do. But as long as the marketplace succeeds, then by definition I think it has found a level of balance that allows the market to exist.

Mr. ENGLISH. Mr. Harris.

Mr. HARRIS. Thank you, Mr. Chairman.

Excuse me, Mr. Chairman. I promoted him. You know, I do not think there is a person on the committee who does not want to see that the integrity of the market is maintained, and I know that is a concern of all of us as well as you. And I know I do not want to see anything done that would drive the business overseas.

So I guess what I am asking you on the question of dual trading, what recommendation would you make to us? I know that, for instance, the cattlemen recommended an outright ban. Of course, our bill is sort of a—it does not, it is not an outright ban. It has got some limitations on it. What would you recommend to do on that?

Mr. MELAMED. Thank you, Congressman, for the opportunity to respond to this important question. And in doing so, I would like to also refer to the chairman's question about the original proposal by the special committee to ban dual trading in mature liquid markets.

That same committee was reconvened recently when the CME's internal committee proposed an alternative to the special committee's ban on dual trading in mature, liquid markets. The special committee unanimously approved the internal committee's recommendation and said that it was fully equivalent to their own recommendation.

In response to your question, the internal committee recognized, as did the special committee, that a delicate balance exists between the perception that dual trading might allow someone—and it is true—to violate the rules—front-running, and so forth, etc.—versus the liquidity dual trading provides.

How do you find that delicate balance? It is suggested that if we could find a way to catch enough of those culprits that would use dual trading to their own advantage and to the disadvantage of a public customer, and if we could do that enough of the time to give us the level of integrity that we seek, then we could preserve the positive aspects of dual trading which is its liquidity. That level is the 90 percent verifiability for the timing of trades through the computerized trade reconstruction system.

And if we can achieve 90 percent verifiability, it is felt that we will catch the wrongdoer enough of the time that we can afford to maintain the dual trading system. The special committee agreed that this approach was clearly adequate and as good as their own approach.

Those markets that cannot achieve the level of 90 percent verifiability will lose the right to dual trade.

Mr. HARRIS. Thank you. Thank you, Mr. Chairman.

Mr. ENGLISH. Mr. Staggers.

Mr. STAGGERS. Thank you, Mr. Chairman.

Following up on Mr. Harris' question, the flaw in that would seem to be that if we set a standard of 90 percent, then we are telling people as long as you only do 10 percent, you are OK.

Is there another way we can do that as opposed to the "any" and "all," language that is in the bill. And I think that is what Mr. Harris was getting at, I think we are looking for ways to get around the "any" and "all," but if we say as long as you work toward the 10 percent, I realize that setting the standards works both ways. That is my question, if we say it is OK for 10 percent, 90 percent is a laudable goal, especially in today's society. But if we do have the increase in technology, I mean, why not have a goal of 100 percent and leave it to the discretion of the CFTC, or whatever?

Mr. MELAMED. We are not saying that if we have 90 percent verifiability, the other 10 percent is OK. That clearly is not in our intent and it is not the way this would work.

The 90 percent verifiability would be accomplished by a system that can detect 90 percent of any untimed trades. The rest of the system, however, is geared to detect anything within that other 10 percent. These trades may be timed correctly. Our CTR system cannot, however, tell us this. All our rules and the package of reforms is very very comprehensive. And we feel that with all these rules together, our exchange will have a surveillance capability we feel is second to none. There is one element we have recently agreed to do, which I would like to explain if I could.

Mr. ENGLISH. Sure.

Mr. MELAMED. What we are suggesting is that every morning, the previous day's record of transactions be given to every member of our exchange within an hour of the next day's opening so that each of the 2,700 members of the exchange, most of whom are not dual traders, can act as policemen themselves. By examining the record of the previous day's trades, they will be able to detect whether any funny trades occurred in their own pit, and come forward with supporting evidence.

As a matter of fact, many of our sanctions today are self-generated, as you know, by the exchange's floor membership. This has never been done by any exchange, and it is only made possible because computerized trade reconstruction—CTR—allows us the luxury of quickly reconstructing the previous day's trades. We can give our members this important tool the next day as another self-policing tool for that additional 10 percent. Indeed, we have many many rules in place that will be more than enough to take care of the other 10 percent, which may be timed correctly.

We are suggesting so comprehensive a package that I believe this committee will be very pleased. I know our goals are the same. I have no doubt that everyone of us has the same goal—to have our markets the most efficient and with the highest integrity possible. I commend you all, and of course the chairman, for moving forward in that direction.

Mr. STAGGERS. Following up once again with what Mr. Harris said, I think I agree with you that our goals are similar, our search for putting together some language which can accomplish that.

My understanding is the system that you have now could do about 90 percent anyway. What I guess I am saying is if we write that into law, shouldn't we—I do not know what you mean by the 90 percent. Shouldn't we have some flexibility to allow somebody else to review this and to say, well, maybe next year, or 5 years from now, you can do better; 95 might be the standard which we want to achieve.

I agree that 100 percent of anything is very difficult to accomplish. And I see the point, but I am looking at it from a legislator's standpoint of how we put together something that is less than the "any" and "all," of the 100 percent. Now, I am searching.

Mr. MELAMED. I am too. I agree with you that we should always try for better. Certainly 90 percent is the goal we have in front of us at this moment. But what we suggested is that we give the CFTC the authority to make the determination whether we have achieved the 90 percent.

We do not want to be the umpire involved, because that certainly would not be fair. We would like the umpire to be unbiased, one with the capability to make that determination, and that is the Commodity Futures Trading Commission.

Mr. STAGGERS. Thank you. Thank you, Mr. Chairman.

Mr. ENGLISH. Thank you very much, Mr. Staggers.

Mr. Sarpalius.

Mr. SARPALIUS. No questions.

Mr. ENGLISH. Mr. Holloway.

Mr. HOLLOWAY. Thank you very much.

I know the testimony has been that undoubtedly the feeling out in America is that dual trading has problems. I would like, just for the record, for the two of you with both the Chicago Board and the Chicago Mercantile, exactly what do your exchanges mean to this country, to the city of Chicago? Knowing that we have been told over and over of the problems that we are going to have with the Japanese taking it over exactly in jobs and money, what do these two exchanges mean to our country, the city of Chicago?

Mr. MELAMED. Thank you for the opportunity to respond.

To the city of Chicago and State of Illinois, Chicago's four exchanges are the central economic engine in that area of the Midwest.

[The supplemental statement submitted by Mr. Melamed follows:]

More than 33,000 jobs are provided by the exchanges, their members and the organizations that provide services to them. Over 110,000 total indirect jobs can be attributed to exchange economic activity. More than $11 million yearly in property taxes is paid on buildings that house the exchanges. Nearly $1 billion is spent annually on exchange-related goods and services in the Chicago area. Member firms have an average of $4 billion on deposit in Chicago banks on a typical day.

Mr. MELAMED. But those are not as important as the fact that our markets are now so central to the financial fabric of this Nation. I would like to relate an anecdote. After the 1987 crash, I met with the heads of those financial firms in New York that are at the top of the financial structure in this country. One of those gentlemen said to me that before you testify in Congress to the Banking Committee on these issues, remember that your markets now are such a financial resource in this country, that we dare not do anything that would destroy or hurt them or drive them somewhere else, because they no longer are simply an out-of-the-way little marketplace. They are now central.

In fact, the Treasurer of the United States, Mr. Brady, called it one market; the securities market, the futures market, and the options market are now one market. Each one of them is such an important element in the overall financial landscape that we cannot exist without any one of them. And, of course, the rest of the world would love to get their hands on our markets.

Mr. HOLLOWAY. Thank you. I mean, I know that we have to be very careful. But I think we have to realize that if we make the wrong move, we very likely could let the Japanese take another one of the many industries they have taken away from us out of our country.

I think we, as a committee, I hope we proceed cautiously. I am not here to tell you that I totally understand the working of the Chicago Board of Trade or the Chicago Mercantile. And I hope to gain in knowledge as we go on to educate myself toward it. But I just hope that we, as a committee, are very very careful with what we do to our country as far as driving this abroad. Thank you.

Mr. MELAMED. Thank you.

The CHAIRMAN. Mr. Chairman, if I might have a question of Mr. Melamed, if you would.

I think you gave a very good, succinct, factual description of dual trading. My perception is that the dual trader is not the problem, but rather if you front run. Then the question I would like for you to address is if the front run may or may not be to the disadvantage of a customer. What is the experience in that area? Just detecting that someone bought for himself rather than for a customer, gives us numbers in a vacuum. You and most of the witnesses here are the experts. We deal mostly from theory rather than from actual experience. We have to accept that and appreciate that. But I would hope that we can put in the record a little more explanation in the whys and wherefores and you address it in part.

Could you help us with that, Mr. Melamed?

Mr. MELAMED. I would be pleased to, Mr. Chairman.

I want to say, first off, that our rules very explicitly label any front running as a violation. Front running simply means that when a broker has an order for a customer in hand, he dare not do a trade for his own account ahead of that order for the customer.

That does not mean that when he violates that rule he automatically injures the customer. That has to be examined in a courtroom or before a committee. Let's say the broker filled the order for the customer and for himself at the same price and everybody got the same price. Of course there was no injury involved. But the rule had been violated just the same.

We look at that very, very strictly. In effect, you cannot and dare not violate the rule of front running. We feel that dual trading does give the opportunity for that kind of thing. That is why we are here and talking about it.

But I must tell you, Mr. William T. Cherry, staff director, of this subcommittee correctly stated to this committee that dual trading is not inherently evil, that banning dual trading does not cure all evil, and that there is nothing that cannot be done without dual trading that can be done with dual trading.

In fact, he indicated that there are only two kinds of violations that can occur because of dual trading: When a broker trades ahead of a customer's order; and taking a position against a customer. This kind of thing is one of the easiest abuses to detect. If you ban it, all you are going to do is allow that dual trader to find a different way to violate. That violation is going to occur if he chooses to violate. And we have to find him anyway.

So you are right in saying that to ban dual trading will not cure the evil involved.

The CHAIRMAN. The next item, Mr. Melamed, you mentioned briefly the problems with the securities industry in New York. And you mentioned your resources as to information.

Could you expand on that? I know that we heard that you were supplying to the SEC information that they did not have readily at hand.

Mr. MELAMED. I could do it best by telling you this incident.

Mr. Nicholas Brady, who is now Secretary of Treasury, headed the Presidential task force investigating The 1987 stock market crash. When he visited our exchange within 1 week or so after the crash, he sat down with us and had a long list of the kind of information that the committee he was heading would need in its study. He asked us how long it would be before we could give him our response to this information, a lot of statistical information about the trades that occurred during the week of October 19. We told him that we have that information, and can give it to you before you leave today.

He was astounded because the securities world was unable to give it to him for weeks thereafter, months in some cases. Yet our Computerized Trade Reconstruction—CTR—system was such that we were able to give it to him within days after the occurrence.

In fact, as I suggested today, we are ready with a reconstructed trade register the day after. No other exchange I know of has that capability in today's world; in the United States certainly.

The CHAIRMAN. Would you also mention briefly your computerized process, your GLOMEX operation?

Mr. MELAMED. I would. What we recognized, Mr. Chairman, was that the competition that we face with the Japanese and the Europeans transcends our working day. Because, you know, the world has now shrunk to a point that these competitive markets are everywhere. People do not wait until our markets open the next morning to trade, to do their hedging, to do whatever they need.

In fact, it used to be we were all protected with a geographical blanket that protected our markets from competition. It is no longer true. So we decided that we must lead our industry to create an "after-hours" system. And the best system to create, we thought, was electronic because that would work best for all 24 hours, the 16 hours that we are not physically open.

We went to the largest communications organization in the world, Reuters, and with them created GLOBEX, an "after-hours" transaction system that will be launched sometime later this year or early next year. For the first time in history, we are leading the financial service world to a 24-hour transaction system. And I must say, everyone has followed our lead, including the securities world.

I notice the over-the-counter industry has moved in the same direction. The security options industry has moved in the same direction. But it was our exchange that led the way. And recently, as you know, the Chicago Board of Trade which created their own system of a similar nature and the Chicago Mercantile Exchange have entered discussions to unify those two systems so that together we could present to the world a cost-efficient system.

The CHAIRMAN. Thank you very much, Mr. Melamed, and let me apologize. I called your GLOBEX, GLOMEX. I have been working on the Mexican foreign debt. And everything has been "mex" for the last couple of weeks.

Mr. MELAMED. I did not even notice that.

Mr. ENGLISH. Thank you, Mr. Chairman.

Mr. Morrison.

Mr. MORRISON. Thank you.

The capabilities of GLOBEX are exciting.

Is there a potential that it sets the stage for the incursion of fully computerized trading on into your normal trading day?

Mr. MELAMED. I do not believe that that is likely in the foreseeable future.

We have yet to prove to what extent liquidity can be generated on a computer. We do not know that. We are experimenting. Now, if you ask me what will it look like 20 years from now, I do not know. But in the foreseeable future, I do not think so. I believe that the electronic system GLOBEX and AURORA, that we hope to launch in the near future, will succeed because it will depend on and key off the liquidity of open outcry that is created in the open outcry fashion during our trading day.

That liquidity will work as the engine to succeed with the electronic market later.

Mr. MORRISON. But it will demonstrate a technology that if and when the institution is ready to move in that direction, it could be utilized as even a replacement for the current human involvement in the pits.

Mr. MELAMED. Theoretically. That is speculative, but theoretically you are, of course, correct. I merely say that I cannot foresee that in a foreseeable timeframe.

Mr. MORRISON. It would be interesting to see how the institution responds. I think your approach to it is a superb combination.

I wanted to ask about something that I do not believe anyone has talked about and that is off floor trading. It is not included in our chairman's bill, and yet without knowing exactly what all was involved in the FBI investigation, maybe a part of what they find that reflects some problems out there.

Could you just give us an overview of your concerns with or how off floor trading could be controlled, regulated, restricted?

Mr. MELAMED. Well, we clearly do not know what the investigation will show. You are correct.

As a matter of fact, our best advice is that not much of the investigation will in fact indicate a lot to do with dual trading. I mean, there are violations involving taxes and there are other kinds of customer cheating that do not have anything to do with dual trading. And there might be some off exchange things that we do not know about, you are right.

Off exchange has always been a problem for the exchanges because we have no authority. In fact, some years back we went to Congress, and together, as you may recall, worked out the creation of the National Futures Association. The NFA is the authority over off-exchange matters, ordained by the CFTC to help the CFTC in such areas as financial monitoring of off-exchange entities, that is entities that are not members of exchange.

And so it is an area that we have some concern with, but we have no authority over. The National Futures Association does an extremely good job in monitoring some of that area. And the CFTC has to do the rest.

Mr. MORRISON. You are comfortable then that NFA and their working relationship with the CFTC adequately covers that area?

Mr. MELAMED. I must in all honesty advise you that I am biased, since I am chairman of the NFA. Yes, I am comfortable and I believe the NFA does an excellent job, but it is very self-serving for me to say so.

Mr. MORRISON. We love confidence around here. It is a product that is all too often in excess supply.

The Commodity Futures Trading Commission yesterday sort of got beat up and I would like to, even though my time is up, just ask one more simple question.

Your general observation working relationships between the exchanges as being essentially self-regulating and the CFTC. And as we go through this process, do the dynamics need to be changed?

Does the level of authority need to be changed? More of an editorial type question, I guess, than a specific one.

Mr. MELAMED. In our workings with the CFTC, although many of our members enjoy when a Federal agency gets beat up and applaud when that happens, I must say that we, as leaders of the exchange, have found the CFTC to be an exemplary agency. It is run extremely well and does a very very efficient job.

As a matter of fact, we have a direct comparison that many of our members do not because we deal with many Federal agencies, not just the CFTC. And in almost every instance, I would say that the CFTC comes out with higher marks than do other comparable Federal agencies. Our experience has been just the opposite. We find the CFTC to be very professional.

As a matter of fact, we are, as you know, strongly in favor of permanent reauthorization for the CFTC. I believe the bill that the chairman introduced also includes that provision, which we support.

Mr. MORRISON. Thank you very much.

Thank you, Mr. Chairman.

Mr. ENGLISH. Mr. Grandy.

Mr. GRANDY. No questions.

Mr. ENGLISH. Leo, I have some additional questions and I think probably some of the other members will too.

I want to ask you to put on the hat that you were wearing on April 19 when you signed the report. With regard to the provisions dealing with dual trading, I noticed in there that it bans dual trading in all contract months that reach the level of mature liquidity.

I suppose the question comes in, and this would be determined by the board of governors and based on market conditions and so on. What is the definition by yourself of mature liquidity?

Mr. MELAMED. Well, we use those words because there is no objective way in which to measure a mature liquid contract. We used them and indicated that it was up to the CME's board of governors. This special committee, in its report, stated that the only way it could make that judgment and feel comfortable about it is if they allowed the market experts to make a determination on a case-by-case basis which market is sufficiently mature and liquid to withstand the hit it might get by losing some dual trading liquidity.

The special committee used the words mature liquidity with the understanding that you could not say categorically which number is right and which number is wrong. And they allowed the board to make a determination market by market, in fact, contract month by contract month. That was their idea and that is how they proceeded.

Mr. ENGLISH. And that basically is the provisions under the bill. The bill sets a certain number. It provides and allows for the exchanges to come before the CFTC. The CFTC instead of the board of governors then would be the one that would make that determination. So they are very similar in that manner as far as where the determination would ultimately end up, the CFTC on one hand, the board of governors of the exchange on the other.

Mr. MELAMED. We have no quarrel with the goal, as we have talked before, of your bill. Our difference is simply that we do not believe that an absolute number is the way to approach this, because we fear that and we do not feel that it is going to work in a practical way, that the CFTC will act in a timely manner.

It might very well be, with all due respect to the CFTC, that they will not act in a timely manner, because the system does not work that way. By the time the illiquidity that has developed around a given market has hurt that market, it is too late to change the requirement. If we lower the requirement from 7,000 to 1,000 and the market is already hurt by it, you cannot bring a market back quickly.

And so, as in many things that are very sensitive, we feel you cannot wade through a process that is, by its own nature, bureaucratic and will not work as kindly as is necessary. We do not want to take that chance.

Mr. ENGLISH. But the point that we come down to though on the issue of liquidity in discussing it with some of your members as well as members from the other exchanges, it is my understanding within the industry generally perceived when a contract hits the level of 5,000 a day, it is generally considered to be mature liquid contracts. Is that not true?

Mr. MELAMED. I do not know that—I mean, these are opinions other than mine, but I do not know that there is such a number that we could say. I know that some small markets are adequately liquid at 5,000 and some are not; some are not liquid at 20,000. It is a question of whether the order flow is constant or at least is consistent every day or every month during the course of the year.

Mr. ENGLISH. But the basic issue that we are talking about here though comes down to the question as to whether it would be, as the proposal was originally intended, whether it would be the board of governors of the exchange or whether it would be up to the CFTC to determine whether a particular contract is a mature liquid contract or not. Is that not true?

Mr. MELAMED. You will note that when our internal committee suggested a 90 percent verifiability threshold instead of mature liquid, the special committee to which you are referring, unanimously accepted that as an adequate alternative to its own proposal. They recognized that there is so delicate a balance between trying to correct the perceived wrong and the loss of liquidity that one cannot be so absolute. They felt that the 90 percent verifiability approach was as good and perhaps better.

Mr. ENGLISH. It is my understanding though that the recommendation that you and the special committee made to the membership met with a very strong rejection, opposition by the membership to those particular proposals. And that these were drafted in place of those as a response to that strong opposition. Is that not true?

Mr. MELAMED. There were vocal objections, of course. There was a segment that does not want any restriction on dual trading, of course. But I do not know that was the vast majority.

The internal committee that wrote the substitute alternative and presented it to the special committee, was composed of people that clearly understood the problem. And no one pressured the special committee to agree that what the internal committee suggested was in every way as good as their own proposal.

I do not believe it was in response to any major objections from our floor. There were some that objected, of course. There are objectors in every society or social structure. But that was not a pressure that our internal committee bowed to.

Mr. ENGLISH. Mr. Coleman.

Mr. COLEMAN. It has happened not just today but yesterday also that we continually forget about the exemptions, exclusions, opportunities for flexibility both written in the bill and in your proposal.

We talk in stark contrast. We are either for dual trading or we are against dual trading. Dual trading is going to dry up the markets or it is not going to drive things off-shore. We cannot talk in terms of black and white, because your own proposal prohibits dual trading. If I wanted to stop at that, it would be a rather unfair characterization.

I think it is very unfair for people to suggest that the bill prohibits dual trading and stop at that, because we provide opportunities to exempt exchanges from the prohibition, and you have addressed those in your written testimony.

At the same time you prohibit dual trading if a market does not come up with a 90 percent standard.

Mr. MARTINEZ. That's right.

Mr. COLEMAN. So let's all be a little more forthcoming in how we discuss these issues. What is it that we do not have in our bill other than "any and all" and the 100 percent verifiability—which is your interpretation, and we understand that? Is it that we do not provide enough flexibility to the Commission to deal with certain problems? Your own proposal provides for the same exemptions, written authorization of the dual trade, for example. We have the spread issue. We have tried to address that. Do you have that?

What is it that is different about the two proposals other than that we have a standard which is higher—but which could be modified. We are open to suggestions and modifications of some sort.

Is there really any substantial difference, Leo, in what we are saying? Other than the degree, I guess, you are at 90, you may think we are at 100.

Mr. MELAMED. Well, other than the degree, of course. The approach is different because ours is based on a 90 percent verifiability of timing of trades, and the proposal of the bill is based on a volume statistic. The volume statistic in itself is an arbitrary number.

Mr. COLEMAN. As a threshold, but also it can be amended by the Commission itself. They could set it at 300,000 contracts, and everybody would be——

Mr. MELAMED. I doubt if they would because that is the point. The Commission is not going to change the will of the Congress, nor should it easily. You would not want that and I would not want that. It would be a difficult process for the Commission to ignore the suggested requirement of Congress. It always is a difficult proposition.

So in the kind of give and take that happens after such a bill that has a number in it becomes law, it becomes almost near impossible to change the number. By the time the number is changed, a given market has suffered and it will be too late to save.

Mr. Coleman. In all due respect, if we were to take your language and draft it into legislation, the 90 percent would be put into law, and you would have the same impact, if a contract could not reach that. True?

Mr. Melamed. Yes, but it is not based on a volume statistic. It's based on a statistic of verifiability of all the trades that occur.

There's one more element that our attorney would like to mention. If I could ask him to with respect to the bill that I have not touched on.

Mr. Salzman. If I could, I hope this isn't too technical, but some of the exemptions are slightly troublesome, especially the one on brokers who make errors. The bill seems to say that a broker who makes an error must wait until the next morning's opening to trade out of his error. The people we've talked to at the exchange have said that it will make it utterly impossible to act as a broker because the range of costs that could be involved in that are just so enormous.

Everybody at our exchange, at least—everybody I've ever talked to—agrees that a broker must be free to trade out of his error immediately, otherwise the cost of brokerage, which is now between $.75 and $1.50 or $1.75 either has to go to an infinite level or these people will not act as brokers. There is just not enough money in it to take those kinds of risks. They are taking $100,000 risks for $20.

Mr. Coleman. These are types of things which obviously can be addressed and modified, and we respect and want and seek your expertise along these lines. So I think we are getting into some, as you say, if not technical, at least some side-stream issues, and I want to pursue a couple of the mainstream issues here, if I might.

This suggestion that we are going to force things offshore is a real easy one. We heard that in 1986, in all due respect, in the last reauthorization. It has not necessarily occurred.

The analogies to the securities markets, if we did not have an insider trading violation of law, there would be some who would say, "If we have such a law against insider trading, we might be driving all the securities offshore." I do not think anybody wants to eliminate that segment of securities law because somehow Tokyo or Taiwan or somebody might open up a market and allow insider trading.

We need to have the safegaurds here, not just because we are afraid of competition, that somebody else will have less safeguards, as long as we do not destroy our markets. So all this driving offshore business is an easy argument which is difficult to suggest that the answer is going to be more suspicion of our markets, less things nailed down, more perception problems that somehow this is going to attract business.

Mr. Melamed. May I respond to the issue of offshore competition?

Mr. Coleman. Sure.

Mr. Melamed. That is not simply an imagined issue. I agree with you that we want to have markets with integrity. Clearly, you are right about that, but unmistakably the issue of offshore competition is very serious.

From 100 percent of futures market share, in the last several years, we have gone to 65 percent. If the auto industry or the microchip industry are examples of what the Japanese can do to our market share, those are serious competitive factors that we as Americans must understand and be very careful with. While I do agree with you entirely that our markets must maintain integrity, we cannot afford to ignore the competitive issues that foreign markets do represent.

Mr. COLEMAN. Have you seen any pull away in our T-bill markets by the Japanese?

Mr. MELAMED. Which market?

Mr. COLEMAN. Treasury or other credit markets?

Mr. MELAMED. Absolutely.

Mr. COLEMAN. Would some of that be as a result of what, what reason?

Mr. MELAMED. The Japanese created markets that attract the business we invented and are taking that business from us. That's true in U.S. bonds, in Eurodollars, and they are now attempting to do so in currencies.

Mr. COLEMAN. But it has not been because of anything that we have slapped on from this committee or the high confidence that you have voiced in the Commission, has it?

Mr. MELAMED. On the contrary. Your committee has thus far been very supportive and in full understanding of the value of this industry. What we are simply afraid of is a change in direction.

Mr. COLEMAN. Let me ask one or two other questions, if I might. The issue of front running, Leo, has been brought up. Front running today is a violation of law because it is fraud. Is that not the case?

Mr. MELAMED. That's right.

Mr. COLEMAN. So there should not be any question that it is already a violation or a wrong that is being looked for by the exchanges and by the Commission.

Mr. MELAMED. That's correct.

Mr. COLEMAN. One final question about dual trading in the audit trail. With GLOBEX going to a computerized trading system, you have in fact constructed something that would change the terms of our bill. Correct?

Mr. MELAMED. On the contrary——

Mr. COLEMAN. Is 100 percent verifiable?

Mr. MELAMED. Yes, but in one respect, Mr. Coleman. It isn't possible to live within the bill because on the computer there should be no ban on the dual trader at all.

Mr. COLEMAN. That is correct because he would be found out.

Mr. MELAMED. Yes, it's 100 percent verifiable.

Mr. COLEMAN. That is what we are saying.

Mr. MELAMED. Exactly, so that your bill would not fit the computer world at all because we shouldn't have any 7,000 or any requirement.

Mr. COLEMAN. You would have met the exemptions, and the dual trading would occur as you directly state. The problem with the dual trader is if you traded ahead, he would be found out because you had a system set up already.

Mr. MELAMED. My suggestion only is this: In your bill you might want to adjust the language that shows the difference between a computer-generated environment and a floor open outcry environment, if I might suggest that——

Mr. COLEMAN. That is indeed the question, isn't it, open outcry?

Let me ask you a completely different question. We had some testimony yesterday about basically the Chinese wall. In the construction of the Chinese wall with a large broker like Merrill Lynch trading for its own account and trading for customers, could you tell us a little about how you look at that Chinese wall? You at the exchange have the power to audit those now, correct?

Mr. MELAMED. Yes.

Mr. COLEMAN. And any problems—have you seen any problems with the breakdown of that Chinese wall, and would you explain what that is for the record?

Mr. MELAMED. Could I ask our attorney to try this one?

Mr. COLEMAN. Yes.

Mr. SALZMAN. We absolutely understand the problem, and we have now created a surveillance tool, a computerized surveillance tool to deal with it. We search the market for large price movements in short periods of time, and then look for all orders entered just before and after those moves, then we can trace those orders back upstairs as well as the floor.

So given that tool, which our compliance people have now created and which will be put into effect very shortly, we believe will be competent to deal with upstairs abuses as well as floor abuses of dual trading or trading ahead of customers. It's a pretty smart idea, I think, and it works because we have the CTR system operating at this point.

Mr. COLEMAN. And the CFTC has not found any problems in reviewing your audit.

Mr. SALZMAN. The CFTC finds problems every time they review us. It's part of their job. They give us a list of 8 or 10 corrections every other year, and they come back 1 year later to make sure we have implemented them. We know that no matter what we do, they are going to find 8 or 10 things we have to correct the next year, and we expect it. It all helps build Leo's confidence.

Mr. MELAMED. That's correct.

Mr. ENGLISH. Mr. Tallon.

Mr. TALLON. Mr. Chairman, thank you. Anybody that wanted to use a broker that was not a dual trader they could certainly have an opportunity to use a broker that was not a dual trader or used the Globex system which is a fully automated system. Is that not true?

Mr. MELAMED. That's true. In the present world, any customer can direct his orders to a nondual trader if that's what he chooses.

Mr. TALLON. Ms. Long was asking some very good questions about stability and liquidity and its impact and effect on stability, and I think your very good answer was that liquidity created stability in the markets. In the legislation that we have before us in trying to define or determine a mature liquid contract with the 7,000 volume traded daily, would it be better in trying to define a mature liquid contract if that was a course that this committee is going to go to—think about the bid-ask spread on any contract traded on any exchange?

Mr. **Melamed**. There is no shorthand rule I know of for determining mature liquid. That's a hands-on kind of approach, feeling the market, seeing the kind of bids and offers the market gets on a daily basis over weeks and months by the people on the floor and in the business and in the commercial area of activity.

I don't know of any rules that can tell you bid-ask or otherwise.

Mr. **Tallon**. And again, I was not thinking about any strict rules, but we have not really—for exemptions that Mr. Coleman talks about in the bill—we have not talked about the CFTC and liquidity period, but if we are talking about liquidity somehow I think we have to look at the bid-ask spread rather than an arbitrary 7,000 contracts traded daily.

Mr. **Melamed**. Well, you're clearly right that the bid-ask spread is an indicator of liquidity. A spread that is consistently small between the bid and offer is indicative of a much more liquid market than is one that has a very big spread between the bid and offer. That was part of the answer that I gave Ms. Long in terms of price gaps.

A large spread between the bid and offer will create large gaps of trade between a price and the next price, and is indicative of a less liquid market.

Mr. **Tallon**. And a less mature liquid contract.

Mr. **Melamed**. Exactly.

Mr. **Tallon**. So, certainly that might be a way to determine liquidity in a contract on any exchange, in my mind, if that had to be done by the CFTC to form what exemptions would be applicable.

Bill, how many traders on the Mercantile Exchange has the Justice Department ever prosecuted specifically for trading ahead of a customer?

Mr. **Brodsky**. None to my knowledge, Mr. Tallon.

Mr. **Tallon**. Bill, if criminal penalties, mandated criminal penalties were written into this legislation for traders that were trading ahead, what kind of impact do you think it would have on people that are involved with dual trading? Would you want to comment on that because that is certainly something that I have an interest in and we have discussed?

Mr. **Brodsky**. Our view generally is that there is certain conduct right now that is violative not only of our rules but of Federal law, and I don't think that there is any need to do anything further. My counsel might be able to add to that, but I believe that our own enforcement program plus the oversight of the CFTC has had a very important prophylactic effect over the last several years to deter this type of conduct.

Mr. **Salzman**. I can only say that I saw the Justice Department's reaction to the proposal. I know they are very nervous for fear that somebody will interpret the change in law as if the previous boss said there was no penalty. We have been cooperating as fully as we can with the Justice Department, and we don't want to support anything that they are against in this matter. I think we have to leave it at that even though we understand what you're trying to do and why it's important.

Mr. **Tallon**. And yet, the Justice Department has never brought criminal charges against anybody for trading ahead of a customer, and certainly if I were a dual trader, which I think can be very beneficial that to provide liquidity and efficiency to these markets, I do not think that I am going to think about the—I am not going to give much thought at all to the illegal practice of front running if that is a part of this legislation. That would be my view anyway. I do not know I would want to deal with trade anymore.

Thank you.

Mr. ENGLISH. Ms. Long.

Ms. LONG. Thank you, Mr. Chairman. I would just simply like to make the statement that right before a market crash you have a high level of liquidity usually due to a high degree of speculation, and what we really need to find in this legislation, what we are willing to do in this legislation is work toward regulations that keep liquidity at a healthy level and speculation at a healthy level.

Thank you.

Mr. ENGLISH. Mr. Grandy.

Mr. GRANDY. Thank you, Mr. Chairman. I apologize to the committee for being tardy this morning.

Mr. Melamed, I wanted to ask you your opinion of something. I have looked at your testimony briefly and hoped to have some time to ask you about some of the things in it. But a couple of days ago, Chairman Gramm was before us, and I asked her a question that related to insider trading, and I asked her for her definition of it as it relates to the commodity exchanges. The definition, at least to this member, was not intelligible.

Can you tell me what insider trading is in your exchange and how do you police it?

Mr. MELAMED. Well, insider trading in the classic sense has to do with, say, knowledge of a corporate report by someone within a corporation knowing the dividend report or how the company is doing or some special product that might be coming out. Those are the classic cases of insider trading.

None of those exist in futures market because the product that is being traded is not corporate-owned. The product that is being traded is everybody's product. Everybody knows the specifications of the product. These specifications don't change. Everybody knows what it is that is being traded.

The only kind of insider trading that occurs in terms of futures markets that come to mind is, for instance, the broker who has an order in his hand from a customer. The broker knows what that order is, and then deals for his own account because he understood what that order from his customer might be. He has some special information that nobody else has. We are very mindful of, and very concerned about that kind of thing.

But the other kind of insider trading that might occur is if there is a Federal report about a market, such as a market report on the trade gap or something from the Labor Department on employment figures, or a cattle report that might be coming out. A Government employee might have that information beforehand, and use that information to his own advantage, sometimes in conjunction, say, with a broker. That would be the same kind of inside information you are talking about.

Mr. GRANDY. And how do you prevent that?

Mr. MELAMED. We prevent that, first of all, by having a strong surveillance force that is cognizant of this kind of thing, especially the first example I used of the trading ahead of the customer order. We obviously have the ability to look at a broker's own personal account to determine every trade he ever made in a given day, and compare it to when he received orders from a customer, and whether they were close in line or not.

Mr. **Grandy**. Well, let me ask you this. Several years ago, our colleague Neal Smith introduced a bill, which never became law, to prevent insider trading, and it reads as follows, and I would just like you to comment on whether or not insider trading could be banned statutorily.

Basically he is amending the Commodity Exchange Act to say:

> As used in this subsection, "insider" means any individual who has access to material information not generally available to the public about present or anticipated cash or futures trading or present or anticipated cash or futures positions for which such individual is not a party in any commodity of any other persons where such trading or positions are in amounts at or above Commission designated reporting levels as specified pursuant to section 4(i) of this act.
>
> No insider shall own, control, have a beneficial interest in or enter into any contract or contract for future delivery in any such commodity on any contract market.

What is the problem with that language?

Mr. **Melamed**. Well, the problem with that language is that it doesn't attack the examples I gave you. What Representative Smith has a problem with is that, for example, a grain company knows it will be selling grain to a foreign body and puts on positions to protect itself with respect to those sales. Under the bill, the grain company would not be allowed to hedge and protect itself.

This is true in cattle or in hogs or in other commodities. These major commercials are using the special inside information they have because they have done the sale, and our markets are exactly for them to use under those very circumstances. They ought to be hedging their forward needs in our market, and using that information to their own advantage, because the advantage for them is that they can continue to make these sales.

The bill would prevent, in fact, the function that is very important of our market.

[The supplemental statement submitted by Mr. Melamed follows:]

> The bill would interfere with the effective operation of futures markets to the overall harm of farmers and commercial market users. It would discourage every professional market user from seeking the information necessary to allow the market to fairly discover the appropriate price.
>
> Considerable information about supply and demand in the marketplace is discovered by the legitimate observation of buyers and sellers. The Smith bill would destroy any incentive to acquire this information, to the extreme detriment of the market.

Mr. **Grandy**. I understand that, I believe, to a point, but do I hear you say that this amendment, this bill that Mr. Smith introduced, I think, 6 years ago, would basically outlaw hedging for large companies?

Mr. **Melamed**. That's right.

Mr. **Grandy**. What about the small investor, what about the small trader who would not have access to this information? Does this prohibit him or does this in any sense give him a more even position with his larger counterparts?

Mr. MELAMED. The theory of markets—and we live within that theory—is that the price structure of the market, the movement itself, is indicative of what's going on in the market. Large commercial buying obviously, or selling, puts a market up or down, and the small investor has to have some understanding why it is going up.

The information generally is available. It is very seldom that you don't know after a period of 1 or 2 days who has been buying and who has been selling as to why the market went up, and then you can make certain assumptions as to why that commercial activity went on, and usually those assumptions are correct.

So that I think the small investor is generally not so at the mercy of not having the information because he has the information of price movement.

Mr. GRANDY. I see my time has expired, so I will not belabor this. I understand the small investor has the information on price movement, but usually after it is too late, and I, of course, am referring to some of the problems that happened in the bean market last week which had a very significant impact out in my area.

Mr. Chairman, thank you.

Mr. ENGLISH. Mr. Nagle.

Mr. NAGLE. The proposals with regard to the disciplinary committee seems to have drawn the ire and hostility of most of the exchanges, but we have not really spent a lot of time talking about it in here.

Could you elaborate a little bit on what your specific objections are to the committee draft with regard to the disciplinary committee composition?

Mr. MELAMED. Our special committee, of which I was a member and Mr. Brodsky was a member, made the original suggestion that there should be an outside member with voting privileges on the major exchange disciplinary committees which will address the perception of clubbiness and closed room kind of decisionmaking. We want to open up the process and show the world that indeed we are not afraid of an outsider being present.

We have no objection with your recommendation in terms of the committee structure.

Mr. SALZMAN. The only real problem—maybe it is a lack of understanding on our part—is the suggestion in the bill that the committee not have a majority of people on it who are in the same class of trader or same class of person as the person being tried. Nobody at the Merc really understood why that was necessary, and we found that it would be counterproductive.

Our clearing house committee, which disciplines clearing members, is made up of other clearing members because they are the ones who understand the clearing operation. There has never really been a sense that we were aware of that anybody felt that that was unfair or operated badly. Moreover, our committee that punishes floor traders for trading abuses is made up of other floor traders, and generally they are the ones most eager to punish the offending floor trader. There hasn't been any complaint about that.

Mr. MELAMED. I didn't know you were referring to the composition in terms of peers. The peers are the ones that know the most about the rights and wrongs of a situation, and are best able to make the judgment.

Mr. NAGLE. Let me yield to the chairman.

Mr. ENGLISH. I will be happy to clarify that since there seems to be some question about it.

The point that was made, and we did through the course of our inquiry, complaints were made to me and to members of the staff that basically it does become difficult for floor traders and brokers is if you are sitting there in the morning and you have to vote against the guy and vote a stiff penalty on him and then turn around in the afternoon and go out to do business with him.

That was the reason for the particular provision. The provision is that you could go outside the exchange if you wished, but it should be someone that does not have to directly do business with that person day in and day out that should make the judgment. It also says the majority, it does not say all, and that is the reason for it.

Mr. NAGLE. Mr. Chairman, let me reclaim my time, let me ask you a question maybe it is as much to the Chair as to the witness. When we are borrowing or when we are restructuring these disciplinary committees, are we doing it on the basis that one pit will not be—we are assuming that everybody on the committee is from the same pit or are they from different pits?

Mr. MELAMED. They are from different pits, and that's a very good point. I was going to respond in that fashion. Our committees are, in fact, comprised of members from different trading pits. In fact, we have a very healthy mix. If you are dealing with a violation that, for example, occurred in cattle, it's very likely that the majority of those members will not be cattle members. We try to structure the committee differently so that you avoid the very situation the chairman correctly indicates is difficult.

Mr. NAGLE. Are the disciplinary hearings open to the public?

Mr. MELAMED. The results of these hearings are public. We are suggesting that one nonmember be on each of those disciplinary committees. That would create an additional element of some outsider presence.

Mr. NAGLE. Would there be a problem if they were open to the public?

Mr. MELAMED. There is a problem in terms of the legal necessities involved with the internal mechanisms of the exchange. I don't think that there has ever been that kind of objection about the proceedings of our exchange. There has been objection that there aren't outside members, and we are trying to correct that.

Mr. NAGLE. What percentage of—what number of disciplinary actions did your committee take last year? Did the various disciplinary committees of your exchange take?

Mr. MELAMED. I think the number is in the testimony, and I'm going to try to find it. While it is being searched for, I will say that it is probably a record we are very proud of in terms of how many cases we instigated, and how many people we penalized.

There were a total of 217 penalties, 313 fines in 1986.

Mr. NAGLE. Wait a minute, 217 penalties and 313 fines? What's the difference?

Mr. MELAMED. Excuse me, the figure in 1986 was 33 participants penalized, in 1987, it was 69, in 1988 it was up 105. The fines were

$313,000 in 1986, $1,715,000 in 1987, $811,000 in 1988. In 1986, there were no expulsions, in 1987, there were eight expulsions and in 1988, there were two expulsions. In 1986, there were suspensions of 238 business days, in 1987, there were 12,392 business day suspensions, and in 1988, 6,110 business days suspension.

Mr. **Nagle**. Two questions. It looks to me that the traders are getting more dishonest as we go or we are getting better at detecting them. We have gone from 43 to 69——

Mr. **Melamed**. Better detection.

Mr. **Nagle**. What is the nature of the abuses they are being fined for, suspended?

Mr. **Melamed**. Well, a lot of them have to do with violations that occur by virtue of getting ahead of the customer trade.

Mr. **Nagle**. Abusing the dual trading process?

Mr. **Melamed**. Abusing that. They have to do with doing something that takes away from a customer the rightful trade, not necessarily getting ahead, but simply taking advantage in another way not giving the customer the rightful trade that he ought to receive.

I am being given a following breakdown of our trades of the violations from the year 1986. It is in table 2 of the appendix to 1988, and here are the following breakdowns, if I could.

Sixty-two were prearranged trading infractions; 15 were trading opposite of customer infractions; 6 were a combination tradings; 14 were outside the exchange hour of pit trading; 3 were disclosing orders; 6 were withholding orders; 1 was trading ahead of a customer; and 5 were fictitious, what we would qualify fictitious trade.

Those are your statistics from your committee.

Mr. **Nagle**. No. The curious thing is that we have 4,369 and 105. How many of those people are still trading on the exchange, all of them, except 10?

Mr. **Melamed**. Well, those that were not expelled and are still not under suspension, I don't know the exact statistics. But once the suspension is over, and if they are not expelled, of course they could go back to the floor.

Mr. **Nagle**. Is there a system on your exchange for—if I run a stop sign once, it's a $10 fine; if I run it twice, it's a $20 fine; if I run it the third time, you take away my privileges? Is it graduated here and time competitive?

Mr. **Melamed**. Absolutely. Absolutely. And the fines are very, very heavy, Congressman Nagle.

As you probably know, our exchange penalties were at the $250,000 limit before the recent structures recommended for everybody. So we have been at a very, very high level, and in fact have generated the largest bonds in the industry.

Mr. **Nagle**. Going back to bring this full circle, with the indulgence of my chairman, you are suggesting—in your statement here I thought you were a lot stronger about the committee's recommendations than, I guess, your initial testimony.

You say we strongly oppose the imposition of composition requirements on exchange of disciplinary committees. It would be rash of Congress to mandate changes in the absence of a documented failure of the current disciplinary committee system.

You are saying, however, you are willing to accept the requirement that, perhaps from us, that there be outside members on the disciplinary committee?

Mr. MELAMED. That's right. We recommended that ourselves.

Mr. NAGLE. Is the problem with the elimination of the peer process the lack of knowledge that would take place on the various disciplinary committees?

Mr. MELAMED. Again, the peer pressure?

Mr. NAGLE. The peer knowledge. I mean if you're working in a certain area, I mean if you're being judged by your peers, your peers are more likely to quickly know that that in fact is a violation or an abuse?

Mr. MELAMED. That's correct.

Mr. NAGLE. Well, I thank the Chair for his indulgence.

Mr. ENGLISH. Mr. Gunderson.

Mr. GUNDERSON. Thank you, Mr. Chairman.

Is it fair to say, having read your testimony, Mr. Melamed, that you would favor just a simple straight reauthorization of present law only making it permanent?

Mr. MELAMED. Well, we recommended many changes that we will offer to the CFTC.

As far as reauthorization goes, we favor reauthorization.

Mr. GUNDERSON. I get the impression that you don't want anything else in the statute, that what you really want us to do is simply reauthorize present law and let any decisions that are made be done by CFTC.

Mr. MELAMED. Well, I don't know how that necessarily has to work because we have made recommendations. I don't want to suggest how that should happen. We expect our recommendations will become law in one form or another, whether they take the form in legislative action by you with an order to the CFTC, or whether they take the form of CFTC directed to us. It won't matter much to us.

Those are decisions I cannot make.

The permanence of the CFTC, if you refer to that, we would like—we agree with——

Mr. GUNDERSON. I see that.

Mr. MELAMED. Yes.

Mr. GUNDERSON. Are you confident that the FBI investigation will not reveal any inadequate regulations by CFTC or any inadequate legislation regarding the whole futures industry?

I mean are you confident that there's nothing in the investigation that will reveal a need for change?

Mr. MELAMED. I would not say that I'm confident because I have no knowledge of what that will show. However, the little bit I have heard, and it is not with confidence that I say so, would not give us the indication that our surveillance system is not good.

Mr. GUNDERSON. And you don't anticipate anything from that investigation on the issue of dual trading?

Mr. MELAMED. I don't know. But I don't think that that is the only focal point or that it will be a main focal point. I don't expect that.

Mr. GUNDERSON. The one area that I am concerned about, as we look at a permanent reauthorization is the whole area of international trading.

You mentioned in your testimony at length on Globex, et cetera. Would you comment on Chairman Gramm's testimony earlier where she had obviously advocated giving them the authority to make investigations for foreign exchanges?

Would you believe that, as appropriate, No. 1, do you believe they have the resources and expertise, No. 2, to do that? And I would like you to be brief so I can pursue some questioning further.

Mr. MELAMED. Well, to the degree we have to give the CFTC the authority to do this kind of investigation, because it often leads to impact on our markets and our prices. We have to know that the integrity on the playing field of our customers in foreign lands is such that they are safe there as well. And the only way that can be done is if the CFTC has some authority to do those kinds of investigations.

Mr. GUNDERSON. Can you give this committee any examples where present regulations impede our competitive ability with other exchanges, such as Tokyo, London, et cetera?

Mr. MELAMED. Present regulations?

Well, the biggest problem we have faced is in authority to launch a new instrument. This requires authority from the CFTC that goes through quite a protracted period of review. And sometimes requires even a nonveto by the SEC.

I will give you an example of the kind of thing we've run into that has given me gray hairs.

It was with the Nikkei 225 stock index which represents the Tokyo stock market. When Clayton Yeutter, who is presently Secretary of Agriculture, was president of our exchange, and I achieved North American contract rights, with the owners of that instrument, the Nihon Keizai Shimbun organization of Japan we wanted to launch that instrument in our futures market in Chicago.

To do that, we applied to the CFTC. And we had to get a nonveto from the SEC.

Four years went by before that was achieved. By then, the Nikkei contract was listed in Tokyo and in Osaka. The stock index futures market began there. We still haven't listed it because we lost the right timing and, to a degree, we lost the market.

Mr. GUNDERSON. How many of your traders also would participate in say the Tokyo, London, or any other foreign exchange?

Mr. MELAMED. Well, it would develop. I do know in the beginning it would be probably small. But it will develop over time, and that's why you need the timing to institute the market so that it can increase in use and development. But I don't know in absolute numbers.

Mr. BRODSKY. I would supplement that by saying that the major firms that belong to our exchange have joined the Tokyo Stock Exchange and the Osaka Stock Exchange so they could trade these products. Because if they're offered there and not offered here, they will participate over there.

Many of the major investment banking firms and trading houses of the United States belong to the Tokyo Stock Exchange for that reason.

Mr. GUNDERSON. Are there varying degrees of standards for participation today in one exchange, here say versus the foreign exchange?

Mr. BRODSKY. There are very differing standards and, in fact, that's an area in terms of international trade policy that we have been involved in. Because there's been what I would call some discrimination against U.S. firms becoming members of offshore exchanges, where we have not had similar barriers. That's an area where we need the understanding and support of Congress.

Mr. GUNDERSON. All right. Thank you.

Thank you, Mr. Chairman.

Mr. ENGLISH. Mr. Nagle has one question.

Mr. NAGLE. Just one question for the record.

We were talking numbers of violations, you know, the 4,369.

How many members are there that trade on the exchanges in a given year?

Mr. MELAMED. Oh, I would say on average, we have 2,700 members, but not all of them, of course, trade. Many of them just own the memberships and lease them out.

I would say there's an average of around 2,000 traders.

Mr. NAGLE. You are hitting less than 1 percent with violation? You're finding less than 1 percent violation by the traders per year?

Mr. MELAMED. That's right.

Mr. NAGLE. I didn't want to leave the impression that everybody on the exchange was engaged in hanky-panky or anything like that.

Mr. MELAMED. I thank you for straightening that out.

Mr. NAGLE. I also did not say that nobody was engaged in violative conduct.

Mr. MELAMED. Well, we know that too.

Mr. NAGLE. Thank you.

Mr. ENGLISH. Mr. Coleman.

Mr. COLEMAN. Let me ask briefly, Leo, questions about the S and P 500 contract and your experiment to ban dual trading from that pit. That was and is a continuing experiment?

Mr. MELAMED. Yes, it is.

Mr. COLEMAN. And the results, as you have put forward in the report of the special committee, are such that it basically hasn't had an impact on the liquidity of the market.

Mr. MELAMED. Well, let me explain a little bit about that.

We didn't actually ban dual trading in that pit. What we did was exclude dual traders from the top step where the order flow comes. Therefore, by doing that, if you want to be a broker on the top step, you can't be a dual trader.

We know that most of the orders in the pit come from, through the top step. We expect that somewhere at the 90-percent level means that the brokers who handle these orders cannot trade for their own account.

While we did state that the impact, we have not measured as a result of the dual trading prohibition, we are not totally confident, because volume did fall precipitously since the time of the prohibition.

However, you will know that at the same timeframe, the 1987 stock crash occurred, and that too was a factor in reducing volume.

So it is difficult to make a concrete judgment how much effect was from one thing and how much effect from the other.

The experiment has given us some confidence but not total confidence.

Mr. COLEMAN. Is it something that we would want to take a look at as a possible legislative alternative to current bills and proposals?

Mr. MELAMED. The top step exclusion is an old idiosyncracy of that market and isn't very transferrable to other markets. We considered that kind of thing ourselves and studied it. But it doesn't work the same.

See, most markets have different idiosyncracies and the order flow is different in each market. And so you really have to make that applicability in a market by market basis.

Mr. COLEMAN. Thank you.

Mr. ENGLISH. Thank you, Mr. Coleman.

Leo, I have only one other question to ask you.

In listening to what you said and looking at what you presented, is it basically your perception that the difference between what the bill is before us and what you're proposing is we're talking about degrees?

Mr. MELAMED. We are talking about degrees and the approach. Our approach is a standard of verifiability. The approach being submitted to us is a number of volume. That's a difference.

And then we're talking about whether you can do a complete 100 percent verifiability or some lesser reasonable number.

Yes, to a degree you're right. Our goals are certainly the same. The approach is somewhat different.

Mr. ENGLISH. So basically we're talking about whether it's 90 percent or whether it's something higher than 90 percent. And the question is: How do we determine this question of liquidity and whether it should be done by volume or whether it be done by some other mechanism, is that right?

Mr. MELAMED. That's right.

Mr. ENGLISH. All right. Thank you very much, Leo. I appreciate your testimony.

Mr. MELAMED. Thank you. I appreciate this opportunity. And I thank you for your work today. I know that it has been a difficult job but a very good one you have done. And we commend you for it.

Mr. ENGLISH. Well, we want to keep working at it. You know, the objective of this legislation is to make sure that we substantially raise the standards up to what we expect in the industry. I know that's an objective that you agree with. It's one that I think will enhance the markets. It would certainly, I think, bring more confidence as far as the public is concerned in the markets.

And I think that's where they go for everyone, and it's for the good of everyone.

Mr. MELAMED. Our goal is common. Thank you.

Mr. ENGLISH. We are going to be looking forward to working with you.

Mr. MELAMED. Thank you.

Mr. ENGLISH. Thank you.

Our next witness is Mr. Robert Wilmouth, president of the National Futures Association.

STATEMENT OF ROBERT K. WILMOUTH, PRESIDENT, NATIONAL FUTURES ASSOCIATION, ACCOMPANIED BY DAN ROTH, GENERAL COUNSEL, AND JEAN TIPPINS, VICE PRESIDENT IN CHARGE OF ADMINISTRATION

Mr. WILMOUTH. Thank you, Mr. Chairman.

And with your approval, I have two of my associates with me at the table. On my right is Dan Roth, who is our general counsel, and on my left is Jean Tippins who is our vice president in charge of administration.

And we thank you for the opportunity to present our views this afternoon.

As envisioned by Congress, NFA never intended to duplicate and has not duplicated the regulatory efforts of the exchanges. That is, the regulation on the exchange trading floors. Rather, our responsibilities to protect the public begin well before and continue well after the execution of a trade. Our members are the firms and individuals that conduct futures business with the public.

Just quickly, our four primary responsibilities include the following:

One, preventing unethical firms and persons from entering or conducting business in the futures industry. We do this by performing a screening and registration function on behalf of the CFTC;

Two, we try to assure that those who do conduct business in the futures industry do so according to high ethical standards. They must comply with the rules which we have developed and which we strictly enforce to protect the public customer;

Three, we do provide through our extensive education programs the information that can help the public make informed investment decisions or, depending on the individual, an informed decision not to invest in the futures market; and

Four, we have established a nationwide arbitration forum that provides public customers with a fair, prompt, and inexpensive means to resolve any disputes which may arise in connection with the trading of futures contracts.

Our accomplishments in each of these areas since the last reauthorization of the CFTC are described in a report which we have provided to each of you.

Now, certain proposed amendments to the act would directly impact NFA in carrying out its responsibilities. And it is those on which I would like to comment specifically today.

There are some others which do not directly impact NFA but, of course, would have a profound impact on the futures industry, and my comments on those areas are contained in my written testimony. But specifically to those that affect NFA:

One is registration requirements. One of the best ways to protect the public from unscrupulous firms and individuals is to keep those people out of the industry in the first place. NFA has been handling this job since October 1, 1985, when we assumed responsibility for denying, revoking, restricting, or conditioning registration for all categories except floor brokers and leverage transaction merchants.

We strongly support the proposed amendments which will not only fine tune and tighten the fitness standards of the futures industry, but would codify certain of the Commission's and NFA's prior interpretations of the existing disqualification provisions and resolve certain ambiguities in the act which NFA has encountered over the past 4 years.

Furthermore, should floor traders, as your bill provides, be required to register under the act, we have the capability to perform that activity.

On the subject of telemarketing fraud, the prevention of deceptive sales practices is precisely where NFA has focused its rulemaking and rule enforcement efforts. We believe this industry's sales practice regulations are second to none in their comprehensiveness, effectiveness, and enforcement. Thus, while we welcome any legislation which would help combat whatever small percentage of persons in our industry who engage in deceptive or high pressure sales tactics, we have serious reservations as to whether the proposed legislation would in fact have that effect.

The proposed rule could unduly be burdensome to the overwhelming majority of our members who are honest, legitimate business persons. Correctly identifying which "first time" customers are solicited by phone could pose substantial problems of practicality in the real world. In addition, there may be sophisticated institutional customers whose trading may not be exclusively hedging for whom this "protection" would be both unnecessary and potentially harmful.

If there is any way to narrow the focus of this concept, to pinpoint the relative handful of unscrupulous firms, NFA could support the proposal and, in fact, we do have some ideas which we would like to present to the committee.

With respect to the issue of public representation on our board of directors, our articles of incorporation have always provided for public representation. Three of the 42 people on our board are elected as public representatives, and their varied backgrounds provide a wealth of industry, legislative, and academic perspectives. But we also have five other members whom we believe qualify as public directors. Three of those represent commercial firms, and the others represent commercial banking institutions. And they give us valuable external insights and counsel.

So if we understand correctly, we are already in substantial compliance with your requirement of 20 percent since 8 of our 42, or roughly 19 percent of our seats, are covered by what we call public members.

The issue of disqualification standards to serve on NFA's board of directors and disciplinary committees is one which we are currently considering, and we think it may well be appropriate to disqualify from board or committee membership persons who have been found to have committed a major rule violation.

We would caution the committee, however, that in determining what constitutes major rule violation, the focus must not be on the rule but on the violation. All of our compliance rules are designed in one way or other to protect the public. The violation of any of these rules could so undermine one's confidence in a person's judgment that he should be disqualified from board membership. Others, however, may only be technical in nature. And the best way to determine a major rule violation is to focus not on the rule that was violated, but on the sanction.

If that reflects the committee's intent, we certainly support the proposed amendment.

We also agree with the committee that registrants should receive adequate trading concerning their ethical responsibilities to customers. Toward that end, we have already made significant changes in the National Commodity Futures exam. The content has been changed to put greater emphasis on an understanding of regulatory requirements, and the exam is graded not only on market knowledge but equally so on regulatory knowledge.

And while these changes have already improved the industry's attention to ethics training, we fully support any proposed amendments which would focus even greater attention on this critical area.

And, finally, NFA strongly supports the proposal to make the CFTC a permanent agency. This would ensure continuing congressional oversight of the CFTC, it would eliminate ongoing uncertainties about the agency's existence, and it would facilitate more effective use of the Commission's resources to regulate futures markets. The proposal is both welcome and long overdue.

Again, we thank you for your attention, and we will be pleased to answer any questions that you might have, Mr. Chairman.

[The prepared statement of Mr. Wilmouth appears at the conclusion of the hearing.]

Mr. ENGLISH. Thank you very much, Bob. I appreciate that.

There has been a good deal of discussion with regard to the question of how we do the telephone solicitation. I know that this committee is not the only committee that has an interest and is concerned about that. And we are looking for ways to strengthen that particular aspect of it. The real question comes down even with the 3-day period that we have after a person is registered.

They file or apply with a firm. Even then we are concerned that the unscrupulous may find a way to maneuver around that particular aspect.

Do you have any specific suggestions as to how we might address that?

Mr. WILMOUTH. Well, we have several thoughts, and I might ask Dan Roth, our general counsel, who has been looking at this, as we thought that might be a possibility to discuss some of the ideas that we do have. And we would like to present them later in detail to you.

Mr. ROTH. Just in general, I think the two points to be addressed are the effectiveness of the proposal and its unintended side effects.

With respect to unintended side effects, just two points we would note in passing, that we would be happy to discuss with staff at greater length.

We might be able to draw some comparisons from NFA's own "know your customer" rule. For instance, that rule, which has proved a very effective enforcement tool for NFA, applies only to customers that are natural persons and not to corporate customers and, therefore, limits the scope of the people that are entitled to the protection from that rule to those people that need it.

Any investor sophisticated enough to incorporate is arguably sophisticated enough not to need the protection of NFA compliance rule 2-30. The same point might be made with respect to a proposed telemarketing fraud provision.

Similarly, our rule requires members to gather certain information from customers such as their net worth and annual income and so forth. The rules makes very clear so as not to be unduly burdensome on our members, that our members can rely on the information provided to them by the customers, and have no due diligence obligation to try to verify or corroborate that information.

A similar type provision for this aspect of the bill regarding whether a customer is a first time customer and whether he was solicited by phone is something that might want to be considered.

In addition, we would like to talk with staff about possibly pursuing this as a means of refining the supervision requirements which are already incorporated into CFTC rules and NFA rules. Clearly what constitutes diligent supervision will vary from firm to firm depending on the nature of the firm's business. For those firms more actively engaged in retail sales, for those firms which have past disciplinary histories, for those firms whose sales forces have come from firms with disciplinary problems, it may well be appropriate to impose upon those firms somewhat different provision requirements. That might be a way to focus the attention of this provision.

Mr. ENGLISH. Mr. Roth, it sounds like that would be an area that we would be very interested in so I hope that you will continue to work on that and consult with both majority and minority staff on the subcommittee.

We are looking for a way of refining down that particular aspect of the proposal. So that would be most helpful and, Bob, we would appreciate that very much.

Mr. Coleman.

Mr. COLEMAN. Bob, let me ask you a question about your new procedures to review promotional material for members.

I believe you have embarked on a pilot project or a program the beginning of May in which people can run materials by an NFA committee and get an approval based upon some facts, which would have to be documented eventually.

You could give an overall approval, a disclaimer, and help basically your members who are trying to conform to the appropriate NFA rules.

If a company does that, comes to you and your review panel, and you give them the approval, do they basically have a defense that you can't come back later, having depended upon that approval and cite them? That's kind of like what we hear from constituents with the IRS. They get misinformation and the IRS says, oh, I'm sorry, that was misinformation, even though the agency gave it out.

What is your position on that?

Mr. WILMOUTH. Let me go into a little bit of background, if I can.

The question of what constitutes proper advertising and what doesn't has been one that our members have been concerned about because what they think they're doing is correct, and then we come along and we slap them with a fine, or we suspend them, or something like that.

What we have attempted to do is to say to them, look, if you submit your advertising to us in general, we will take a look at it, and we will tell you whether or not we think it's going to comply with our rule. We are going to do that within a period of 3 weeks, and this is on a trial basis.

It would be my feeling that it would not necessarily, and I may have to refer to legal counsel, would not necessarily exempt them from any punishment from us if we found out later on that they had twisted it.

But if somebody comes in and presents a piece of advertising and we say that it looks OK, and it continues to be used in that exact same format, I would think we would have a difficult time of proving that it was wrong if we had put our blessing, our stamp of approval on it.

But essentially it's just to give them a general overall approval of the approach they're taking.

Mr. COLEMAN. OK. Now, previously, under the old methodology, you would perhaps take what you might call a no action position. You would not approve in a positive sense but you wouldn't disapprove?

Mr. WILMOUTH. No. What we used to do before was to require certain firms with whom we had a problem to submit their advertising to us in advance. We made that a specific requirement. If we did an investigation of a firm and we brought them to the attention of our business conduct committee because of the fraudulent advertising that they were using, or the misleading advertising, one of the sanctions might be you must submit that advertising to us in advance, and they would have to do that. Otherwise, they would be in violation of our order.

And this was to make certain that any of those who were a problem in the past had an opportunity to come in and present new material in advance and get kind of our imprimatur or blessing or seal of approval, "Good Housekeeping" seal of approval in a way.

Mr. COLEMAN. Would you indeed give your approval, or would you take a nonaction?

Mr. WILMOUTH. No. We basically, if they submitted the advertising to us in accordance with our request, and we saw nothing wrong with it, we would let them go ahead and use that advertising.

Mr. COLEMAN. I see.

And what if it was not a problem firm that didn't get a request from you to submit this, what would be the normal course of the firm?

Mr. WILMOUTH. If we felt it was serious enough, we would bring an action or a complaint against them, and bring it to the attention of our business conduct committee.

In many cases, I must say that when we bring that to their attention, they would stop using it immediately, and then there would be no new cause to go after it because it would be an honest misinterpretation of what they felt would be OK before we brought it to their attention. Then they would refrain from using it.

Mr. COLEMAN. But previously if the firm had not had problems, but had submitted something to you, you would have said——

Mr. WILMOUTH. We didn't have a program like that——

Mr. COLEMAN. You didn't have a program?

Mr. WILMOUTH. Until just recently. This is our new pilot program——

Mr. COLEMAN. So there was no way of doing it before?

Mr. WILMOUTH. That's right.

Mr. COLEMAN. And no one would have said, well, the fact that we are not going to approve this doesn't mean we are disapproving it either?

Mr. WILMOUTH. That's right. What we kind of felt as we got along, and you have got to remember, NFA is a relatively new organization, it began in 1982, we tried to put out some interpretive notices as to just exactly what we felt would be good or bad in a particular area.

And I think advertising is a very difficult one to do. And some of our members were effectively saying, we think that you're cracking down on us when you really shouldn't be. That's why we have devised this recent program.

I must also say that we spent a lot of time, particularly in our early years, and still do, assisting a lot of our members in terms of helping them not only set up books but also determining what is and what isn't proper advertising or proper activities with the customer.

Mr. COLEMAN. Thank you.

Mr. ENGLISH. Well, thank you very much, Bob. I appreciate your testimony and we are looking forward to working with you.

I think that one provision is an area that we can strengthen and we look for the help NFA can do.

Mr. WILMOUTH. I certainly will. We'll have something to you next week. Thank you.

Mr. ENGLISH. Let me also say that we have received letters commenting on this bill, and we expect to receive statements from a number of other organizations. Any statements, written statements that are submitted to the subcommittee will be included as a part of our record.

[The prepared statement of Ms. Vogel appears at the conclusion of the hearing.]

Mr. ENGLISH. We will now recess until 2 o'clock, when our next witness will be Mr. Karsten Mahlmann who is with the Chicago Board of Trade.

[Whereupon, at 12:55 p.m., the subcommittee recessed, to reconvene at 2 p.m., the same day.]

AFTERNOON SESSION

Mr. ENGLISH. The subcommittee will be in order. Our next witness is Mr. Karsten Mahlmann, who is chairman of the Chicago

Board of Trade, and I see that he has individuals accompanying him.

Mr. Mahlmann, we are going to let you introduce the gentlemen that are with you.

STATEMENT OF KARSTEN MAHLMANN, CHAIRMAN, CHICAGO BOARD OF TRADE, ACCOMPANIED BY THOMAS DONOVAN, PRESIDENT AND CHIEF EXECUTIVE OFFICER; DONALD ANDREW, MEMBER, EXECUTIVE COMMITTEE OF THE EXCHANGE; SCOTT EARLY, GENERAL COUNSEL OF THE EXCHANGE; FRED GREDE, VICE PRESIDENT IN CHARGE OF THE OFFICE OF AUDITS AND INVESTIGATIONS

Mr. MAHLMANN. Mr. Chairman, thank you very much for letting us appear before your committee to address H.R. 2869. With me this afternoon are, to my right, Mr. Thomas Donovan, president and chief executive officer of the Chicago Board of Trade; next to him, on the right, Mr. Donald Andrew, a member of the executive committee of the exchange, a member of the board; next to my left, Scott Early, general counsel of the exchange; next to him, Fred Grede, vice-president of the exchange in charge of the office of audits and investigations.

Mr. ENGLISH. I want to repeat what I said earlier this morning. Anyone testifying this afternoon and summarizing their testimony, without objection their full and complete written testimony will be made a part of the record.

Mr. MAHLMANN. Thank you very much, Mr. Chairman.

Mr. ENGLISH. So, we'll turn it to you.

Mr. MAHLMANN. Mr. Chairman, I am here to present the views of the Chicago Board of Trade on H.R. 2869, the Commodity Futures Improvements Act of 1989.

Among other things, this legislation makes the CFTC a permanent Government agency. The Chicago Board of Trade endorses that action. While we do not agree on everything with the CFTC at all times, we respect the important role played by a mature and expert agency in overseeing the self-regulatory scheme embodied in the Commodity Exchange Act. The vote of confidence reflected in H.R. 2869 for the CFTC is well-deserved.

Mr. Chairman, in sponsoring H.R. 2869, you indicated that you wanted to promote both the integrity of U.S. futures markets and our ability to compete with foreign markets. We share these objectives, but disagree with how some of the provisions in H.R. 2869 would accomplish them. We would like to propose alternative provisions that would accomplish the same objective of elevating industry standards.

The Board of Trade is committed first and foremost to maintaining the integrity of our markets. In the past week, we saw a demonstration of the depths of our commitment. As you know, on July 11, the Chicago Board of Trade took emergency action to remove the threat to an orderly liquidation of the July 1989 soybean futures contract. It took courage to take this action because we knew we would be criticized by some, but we acted, nevertheless, because of our commitment to preserving marketing integrity and because strong, self-regulatory medicine was needed. As Secretary of Agriculture Clayton Yeutter said, "The Board of Trade has nothing to apologize for. Preventive medicine is better than curative medicine."

As this recent episode shows, the Board of Trade will not hesitate to take decisive action when needed to maintain investor confidence. We welcome further discussion on the soybean issue at the conclusion of my testimony.

As a reflection of confidence in our markets, investors are participating in futures markets at ever increasing levels. Over the last 4 years, the Chicago Board of Trade volume has grown by 92 percent. During that same time period, foreign futures exchange volume increased by over 226 percent. Foreign countries are waking up to futures trading and to economic and social benefits that futures trading provides.

Even though U.S. futures industry volume has increased over the last 4 years, market share has decreased by 10 percent. Foreign futures exchanges now account for 30 percent of total futures volume for exchanges gained in market share exclusively at the expense of U.S. futures markets.

U.S. exchanges do not have a monopoly on the products they trade. The Board of Trades most active product, U.S. Treasury Bonds, is now listed for trading in London, Sidney, Singapore, and will be traded later this year by the Tokyo Stock Exchange. The Chicago Mercantile Exchange's most successful product, Eurodollars, is traded in London, Singapore, and now the Tokyo Financial Futures Exchange. Our products and our success are the envy of the world.

Why do we cite foreign competition? Many industries have come before Congress to ask for protection from foreign competition. We seek no such protection. We ask only that you not inhibit our ability to compete with these growing markets. The U.S. futures markets are already the most heavily regulated in the world.

We recognize the competition facing U.S. financial markets. In the Far East, virtually unlimited capital is available. At the same time, European countries are uniting economically to develop a true common market in 1992. The European community recognizes the formidable economic position of its international competitors, and is taking steps to meet those challenges.

Faced with these trends, the U.S. futures industry has taken measures to strengthen our markets in a cost efficient way. In today's environment, we are attempting to create a unified front to manage our future direction.

The Chicago Board of Trade and the Chicago Mercantile Exchange recently announced that discussions would begin in an attempt to unify Globex and Aurora, the computerized trading systems developed by each exchange. By creating a unified trading system, we believe that we can lower the cost of doing business to market participants, making us more competitive with the rest of the world.

The Chicago Board of Trade and the Chicago Mercantile Exchange recently also agreed to unify their electronic audit trail, the Computerized Trade Reconstruction System, combining the best of the Board of Trade system with the best of the CME's approach, creating the potential for an industrywide standard.

In addition, the Board of Trade and the Mercantile Exchange have agreed to unify their existing computerized surveillance programs, CATS by the Mercantile Exchange, CTR Plus by the Board of Trade.

The unified system will review 100 percent of trading activity at both exchanges. No trade will escape the exchanges' computerized microscope. As a result, both exchanges will operate a new and improved audit trail and surveillance to detect those trading violations that are attributable to dual trading as well as other types of potential trading abuses.

Moreover, the subcommittee should not lose sight of the fact that the existing Board of Trade audit trail and surveillance capabilities already meets the highest standards. As U.S. Attorney Anton Valukas has publicly stated, "They—the Board of Trade—have the resources to identify trading practices in which fraud has occurred."

The Board of Trade has already passed new regulations in a number of areas. Our audit trail is becoming tighter with new time stamping systems and narrower timing requirements. Computer surveillance has been upgraded. Surveillance personnel have been increased by more than 30 percent in order to adequately handle the task at hand. New rules and broker associations and opening and closing procedures have been passed. Both the Board of Trade and the Mercantile Exchange are implementing new technological innovations, including the advent of electronic audit delivery systems which will insure that customer orders have the most accurate audit trail possible.

In summary, the Board of Trade already has taken steps to insure enhanced customer confidence in our markets which will strengthen our ability to provide liquid and fair trading markets to the world.

As I mentioned earlier, we support many provisions in H.R. 2869. We applaud the legislation's primary objective to insure good, clean, honest markets. However, we recommend that certain provisions be modified in order to permit the efficient functioning of U.S. futures markets to continue.

First, we oppose the provisions in H.R. 2869 that would ban dual trading. We believe there is a way to preserve the benefits of dual trading while also protecting against a potential for abusive trading practices. This proposal eliminates the benefits of broker trading without considering the cost inherent in doing so. We strongly recommend that a cost benefit analysis be prepared regarding the specifics of this proposal before it is legislated.

Mr. Chairman, I think we can all agree that dual trading, per se, is not bad. In fact, dual trading contributes significantly to market liquidity. What is bad is when brokers front run customer orders to gain a financial advantage. To address that misconduct, the Board of Trade and other exchanges have had rules on their books that prohibit brokers from trading ahead of customer orders. Any member violating that prohibition faces a full range of exchange-imposed penalties from substantial fines to expulsion.

Moreover, any approach to the topic of dual trading must be consistent and comprehensive. This proposal only addresses floor trading. The Presidential task force on market mechanisms, known commonly as the Brady Commission, found that "the markets for stocks, stock index futures, and stock options are in fact one market." Therefore, to address the dual trading question properly, a review of all dual trading on exchange floors and off exchange floors both in futures and securities as well as the ultimate dual trader—the specialist—should be required. As currently provided, this proposal does not foster a level regulatory playing field. Off-floor dual trading would permit an FCM or its employees to front run customer orders. Nothing in this proposal addresses this possible abuse.

Demonstrating another inconsistency in this proposal, the CFTC, on Monday of this week, approved the trading of commodity SWAPS without any Government oversight. SWAPS are direct substitutes for futures contracts. Those who engage in commodity SWAPS will be permitted to dual trade completely outside the regulatory oversight of the CFTC or of this committee. H.R. 2869 will not touch this unregulated market where dual trading will occur regularly.

The proposal to ban dual trading will adversely affect the liquidity of futures markets, particularly so, agricultural markets, by increasing the cost of doing business. The pricing impact on U.S. agricultural futures markets will also adversely impact the pricing of physical agricultural products traded in this country.

We recognize that H.R. 2869 includes certain exemptions from dual trading prohibitions designed to permit flexibility for the CFTC on a contract-by-contract basis. In effect, however, before the CFTC can use these powers, the markets must be illiquid and potentially irreparably harmed.

H.R. 2869 also exempts any Board of Trade from the trading prohibition if its audit trail is fully verifiable and can detect any and all abuses. However laudable, this standard is unattainable in the real world. The imposition of this perfect standard would bring our business to a halt. We believe that a more realistic approach would be to exempt any Board of Trade from the dual trading ban if the CFTC concludes that the Board of Trades audit trail and surveillance systems provide for the effective detection of statutory and regulatory prohibitions.

With respect to the audit trail proposal, we again find the objective of the bill's drafters laudable. No exchange in the world has demonstrated a greater commitment to the implementation and usage of advanced technology in its audit trail system. In the absence of a definition of verifiable, we believe a 30-second standard should be a goal since it is not achievable with current technology. We suggest a more flexible approach which would permit the exchanges to work with the CFTC to research and develop technological enhancements to the audit trail rather than legislating standards.

Finally, with respect to make-up of disciplinary committees, the current proposal, contrary to the fundamental premise of our system of justice would dictate that an accused member not be tried by a jury of his peers. Disciplinary hearings are extremely serious matters. This proposal severely affects the rights of the individuals involved. As U.S. Attorney Anton Valukas recently stated, "In my estimation, based on my own expertise in the area, the best experts in the world concerning trading practices are the members of the Board of Trade." This statement was made while the alleged undercover investigation was supposedly going on.

In summary, Mr. Chairman, we can endorse many provisions in this bill, but others may have serious and irreparable adverse ramifications on the liquidity, pricing, and operation of U.S. futures markets.

We will be happy to work with this committee to develop effective legislation for the regulation of U.S. futures markets. We share this committee's concern to uphold the integrity of our markets and maintain continued customer and investor confidence. We must stress to this committee that the U.S. futures markets are the best regulated in the world, and as such are the envy of our foreign competitors. We cannot afford to hand our markets to those competitors. Unless we are careful in the crafting of this bill, we will tilt the regulatory playing field in their direction.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Mahlmann appears at the conclusion of the hearing.]

Mr. ENGLISH. Thank you very much, Mr. Mahlmann. I appreciate that.

It would appear, in going through, I was taking note of the fact that it would appear, with the exception of the disciplinary committee question, that the general disagreement—generally speaking—the disagreement with this legislation has more to do with degrees than it does with regard to the objective itself, the question how far can we go, how much can we accomplish.

Would you agree that that is the basis for the disagreement at this point?

Mr. MAHLMANN. Mr. Chairman, as I have stated in my written testimony that I just read, we wholeheartedly agree with the goal of the committee and with the proposal in the bill. It is a question of degree and how do we get there without impacting the liquidity of the marketplace, but at the same time detecting virtually all abuses; "any and all," that's difficult.

Mr. ENGLISH. Let me speak to that at this particular point. The provision of "any and all" is subject to definition. I think the real question is the issue of whether this legislation is going to encourage through a carrot and stick approach, and many within in the futures industry have stated that they thought that that approach is a proper one, the question of how far can we go, what kind of standards can we expect.

This subcommittee has not, and of course we will as we move through the legislative process define exactly what that means. We deeply appreciate and look forward to working with the Board of Trade in reaching a definition that quite frankly is ambitious but by the same token obtainable.

So, we do look forward to working with you on that, and we appreciate the offer of helping us in that matter, and we will be calling on you without question on that. So that is deeply appreciated.

Let me state that there have been a number of questions with regard to the issue of the action taken last week by the Board of Trade pertaining to soybeans. I have two questions. The first one is the question given the existing situation in the market—in the soybean market—is it possible that the Board of Trade may have to take some more action next month?

Mr. MAHLMANN. Mr. Chairman, the Board of Trade, through its committees and through its staff in the office of audits and investigations is daily monitoring the August contract which is now the nearby delivery month. I strongly hope, as the chairman of the exchange, that similar action will not be necessary.

Mr. ENGLISH. But it cannot be ruled out.

Mr. MAHLMANN. I cannot state that it will not be.

Mr. ENGLISH. OK, that is very good. I appreciate that.

The next question is one that we addressed to the CFTC when Chairman Gramm appeared before us on Tuesday, and that gets into the question of the decisions or the action that led up to this decision and the involvement of the CFTC. As the law stands now, of course the CFTC has the authority, should they disagree with the action of the Board of Trade, to overrule that action, but there is nothing in the law as it stands now for the CFTC to, in effect, respond in the affirmative unless they so desire.

Several members of this committee made the point, and I think rather forcefully, that given the fact the CFTC was notified in advance of this decision being announced that no statement, no response is tantamount to approval, and I think there is a great deal of interest in this subcommittee as to exactly what involvement the CFTC had in the decision, and what was the interaction between the exchange and the CFTC on finally reaching this decision.

Could you give us an overview of exactly, and in as much detail as possible, what the interchange, the interrelationship was between the CFTC and the Board of Trade?

Mr. MAHLMANN. Mr. Chairman, if I am permitted to step back for a moment in time, I will go back to approximately the first week of June. We had just come through a May expiration that we all were very happy that had got done by the skin of our teeth, but it did get done without any emergency.

Even through that time, we were in daily contact, and from then on forward, with regard to the July contract, we were in daily contract with the Commodity Futures Trading Commission, both at the staff level and from chairman to chairman, and there was intimate dialog, going on into the emergency action that the Board of Trade took from myself to Chairman Gramm on an almost daily basis.

Mr. ENGLISH. With this interaction, this daily contact between you and the chairman and between other members of the Board of Trade, and I assume other members of the staff of the CFTC, perhaps other Commissioners, did the Board of Trade at any time make any recommendations or did the CFTC make any recommendations to the Board of Trade contrary to the decision that the Board of Trade took?

Mr. MAHLMANN. Mr. Chairman, the CFTC arrived independently of the Board of Trade on the same day at the identical conclusion that the Chicago Board of Trade Board arrived at in its special board meeting of the afternoon of July 11. The CFTC, independently of the exchange, determined that there was a threat to orderly liquidation of a contract, which is the same foundation that—and the same decision that the Board of Trade board arrived at on the afternoon of July 11.

The actions that were then taken by the two parties vary to some degree and are identical to another degree, if I may elaborate.

Mr. ENGLISH. Please do.

Mr. MAHLMANN. The Commission in coming to the decision that a threat of orderly liquidation existed came to the conclusion that it notified a single market participant that effective the close of 3 days before the expiration of the contract its anticipatory hedge exemption from speculative limits would be revoked.

Putting it into plain english, it said the major market participant on the long side, singly by himself had to come down to 3 million bushels as of the close of the 18th. The Commission so notified the market participant.

The Chicago Board of Trade board, on input and advice, and seeking of help from the business conduct committee, addressed the same issue on July 11 at 2:15 in the afternoon. The Chicago Board of Trade board independently reached the conclusion that there was a threat to the orderly liquidation of a contract, that if it was not addressed could lead to the potential default of the contract.

The Board of Trade board then, in its order, acted across the market, meaning market neutral, not against a single participant but market neutral against all market participants insofar as anybody that held in excess of 3 million bushels, whether it was hedge or not, was not the deciding factor, was not a material factor. The concern was orderly liquidation.

Therefore, anybody with positions in excess of 3 million bushels had to reduce those positions in a gradual step way, 20 percent per day, down to a figure of no more than 3 million bushels as of the close of July 18.

The end position on July 18 in the Board of Trade's order and the CFTC order are identical. The Board of Trade's order applied to all market participants, whether long or short. The Board of Trade's order incorporated gradual steps. The Board of Trade's order was taken ever mindful of our obligation to have orderly markets, and particularly so, orderly liquidation, and it did not address a single market participant.

The Board of Trade order, in its final step, at the expiration of about 45 minutes ago, also included a provision that no market participant could go off the board, meaning, have a position open after the final bell of trading in excess of 1 million bushels.

But yes, both parties, regulator and the market, took independent actions along the same lines.

Mr. ENGLISH. Mr. Coleman.

Mr. COLEMAN. I am going to go over the same ground a little bit with you for emphasis. First of all, this intimate communication that occurred between the Exchange and the Commission started back in early June; correct?

Mr. MAHLMANN. Congressman, it started before that on the May contract. With regard to the July contract, in early June, yes.

Mr. COLEMAN. In early June. And was that primarily conducted between you as chairman and Dr. Gramm as chairman, or were others involved?

Mr. MAHLMANN. The staff of our office of audits and investigations and the staff of the Commission were as well in daily contact.

Mr. COLEMAN. And during such periods of time, do you feel and is there a confidentiality issue involved to the extent that you do not share that information with others?

Mr. MAHLMANN. There is very much a confidentiality issue involved. Our office of audits and investigations is ever mindful of that obligation that they have as staff members of the exchange, and so am I as chairman.

Mr. COLEMAN. So I would take it that other than yourself, there was no other board member who was involved with or familiar with or was related to any information regarding this?

Mr. MAHLMANN. The only participants knowledgeable in the dialog were the two gentlemen sitting to my left: General counsel of the exchange and vice president of the audits and investigations department. No board member was knowledgeable.

Mr. COLEMAN. I am sorry? No?

Mr. MAHLMANN. No board member was knowledgeable.

Mr. COLEMAN. Now, the CFTC—I am not sure what we are going to call this. The CFTC informs a major participant, your statement said: Was that through an informal proceeding, to your knowledge, or was there an order issued? How would you characterize this communication?

Mr. MAHLMANN. They directed the major participant in writing that his previously granted hedge exemption would be revoked for the last 3 trading days of the July contract.

Mr. COLEMAN. Did they inform you of this action prior to its being taken?

Mr. MAHLMANN. No. They informed me after they had taken it.

Mr. COLEMAN. Had you been in discussion with them about a possibility of some action being taken, and was this one of the alternatives that had been discussed?

Mr. MAHLMANN. Congressman, we had been in daily discussions of what alternative steps could be taken. They did not discuss what they would do with me.

Mr. COLEMAN. Under the circumstances, and while this is an unusual circumstance, is it your feeling or is it your opinion that the Commission was to give the exchange the first right to move in such a case? Or do you feel that you—I mean, who was waiting for whom to move here? I guess that's the question.

Mr. MAHLMANN. Congressman, I have to take you back to the chronological event of how the last occurrence occurred. Within the exchange, the monitoring of orderly markets, and particularly so the monitoring of an expiring futures contract, is delegated to the business conduct committee. The business conduct committee is a sworn-in committee by oath to keep the secrecy of any item that came before them on any issue, and they standardly go through the procedure of recusal, and having been asked for a recusal if there is any party involved in a particular commodity.

That committee has been continuously monitoring the July contract. At various instances through the month of June and into July did this committee call in market participants, both long and short, and reminded them of their obligation to effect orderly liquidation of a futures contract. At the last meeting prior to the decision, the business conduct committee instructed a major participant that, under its obligation to orderly liquidate positions, it would have to do so on a daily basis in a reasonable fashion. And the committee told the major market participant—and this meeting occurred on July 6 and was followed up by a letter of those instructions on July 7—that the committee would deem 3 million bushels a day reasonable liquidation.

The committee also notified the major market participant if the participant would not abide by the guideline and directive given to it by the business conduct committee, the business conduct committee, seeing that it had no powers themselves to effect liquidation within the rule structure, would have to present to the board the case that they deemed emergency action in order to ensure orderly liquidation would be necessary.

The business conduct committee monitored for 2 days the action of the major participant, and when they did not find adherence to the proposed guidelines that they had given—meaning 3 million per day liquidation—at that point the business conduct committee recommended to the board to take emergency action.

Mr. COLEMAN. Well, my question is: Should there be some sort of structured process by which the Commission on its own not only could have but should have made these decisions and acted prior to what you have just related to me by the exchange?

Mr. MAHLMANN. Congressman, I believe that the exchange, being intimately involved in the marketplace and monitoring on a daily basis, is a better judge of whether an emergency exists or not.

Mr. COLEMAN. And even though the Commission had concluded the same thing, how did they conclude that, other than based upon information that you gave them?

Mr. MAHLMANN. Congressman, I can comment on the Board of Trade's conclusions. I cannot comment on the Commission's conclusions of how they arrived there.

Mr. COLEMAN. But any information that they received would have had to have been relayed by you? Or how would they have determined that?

Mr. MAHLMANN. Congressman, I presume the Commission and its staff also draws its knowledge from independent sources.

Mr. COLEMAN. And when we have an information letter, I guess we will call it, from the CFTC that basically required this major market participant to do the same thing that you ordered them to do: What is the difference as far as the effectiveness goes of what a Government commission tells somebody to do—which apparently they were not paying attention to because you had to then follow up with some sort of action on your own? Is that correct?

Mr. MAHLMANN. The two actions occurred independently of each other on the same day.

Mr. COLEMAN. On the same day.

Mr. MAHLMANN. Yes. But with respect to your comment on the difference of the two actions, why did we have different actions, the Board of Trade's action applied equally across the market. The Board of Trade's action also incorporated a gradual day-by-day 20 percent reduction requirement. The potential of the Commission's action would have been that the major market participant, out of 23 million bushels—and I can mention the figure because it was stated in public court—might have elected to sell 20 million bushels on 1 day. I have no idea what that impact would have been on the marketplace.

Mr. COLEMAN. Well, is this an informal rule as far as having the participant know that they are going to have to liquidate their position? Is there an exchange rule, or is this an informal rule?

Mr. MAHLMANN. The Commission has its own rule, and the Board of Trade has its right in its charter and bylaws under emergency action.

Mr. COLEMAN. That is your authority?

Mr. MAHLMANN. So both parties have the authority.

Mr. COLEMAN. Yes. Well, the story in this morning's Wall Street Journal characterizes this as a violation of an unwritten rule of the Board of Trade. Is it, in fact, an unwritten rule, or is it a written rule?

Mr. MAHLMANN. The Wall Street Journal must be referring—and I can only speculate on that—to the job awning which is the only thing that the business conduct committee can do. The Board itself under rule 180 of our exchange has the emergency powers rule that can mandate market participants what to do in order to achieve orderly liquidation of a contract, which is in turn demanded of us under the Commodity Exchange Act.

Mr. COLEMAN. All right. Thank you.

Mr. ENGLISH. Mr. Combest.

Mr. COMBEST. No questions.

Mr. ENGLISH. Mr. Tallon.

Mr. TALLON. Mr. Chairman, thank you.

Mr. Mahlmann, I believe you testified that 100 percent audit trail that would detect any and all abuses would be an impossibility for you to have in place, that kind of audit trail.

What is your accuracy rate with the audit trail that you have at that Chicago Board of Trade now?

Mr. MAHLMANN. The last CFTC review and substantial steps have been taken since then indicate that the CFTC finds the Board of Trade audit trail or the logic that leads to the Board of Trade assignment of times in its audit trail that it could presume an 88 percent accuracy.

Mr. TALLON. The liquidity with the banning of dual trading when a contract reaches a volume of 7,000 contracts on a daily basis, the threat to liquidity which brings more stability to the market is certainly something I am concerned with.

Is this 7,000 volume in a contract? Why isn't that a mature liquid contract when you reach the 7,000 volume?

Mr. MAHLMANN. Congressman, I cannot tell you when a contract is mature and when it is not mature. I have never heard any criterion used on that before.

What we had proposed because we embraced the committee's goal of getting to good clean, honest market that substantially detect virtually every abuse that there is. The exchange just approached, if it can offer that to the committee, would be that an audit trail through computer technology and surveillance systems through computer technology that reach as a nearby goal a 90 standard and then as additional technology becomes available that

that goal be increased, that that be the measure rather then the contract volume.

Contract volumes change. One contract can be liquid today, illiquid tomorrow. We think that is a better implementation rather than taking the liquidity which dual trading prevents out of a marketplace.

Mr. TALLON. You think you could reach a 90 percent accuracy rate in 18 months?

Mr. MAHLMANN. I strongly believe so.

Mr. TALLON. You mentioned off-floor dual trading. I guess you were talking about people like a futures merchant or brokerage house receiving orders. Certainly in the securities market, certainly specialists on the New York Stock Exchange. I believe you said they were the ultimate dual trader in the things that we would have jurisdiction over or direct the CFTC to look at.

What kind of job in just those areas like a futures merchant where orders come into brokerage house, what kind of job has this bill done in addressing any possible or potential abuse of dual trading?

Mr. MAHLMANN. Congressman, it is my feeling that this bill has singled out on-exchange dual trading only. It has not addressed dual trading if it is taken in the same vein as a broker trading for himself and for his customer. That can occur off-exchange, that can occur in the futures industry, that can occur on the securities industry, that can occur upstairs on private trading desks, and that can occur on the New York Stock Exchange within the specialists, and it can occur not only in the CFTC regulated industry, it can occur in the SEC regulated industry.

So my view is that H.R. 2869 only addresses this on exchange floors while leaving all the other industries untouched in its auditorial requirement, and I submit to this committee that would put exchange floors on a tougher standard than either another industry or any other part of the industry.

Mr. TALLON. Are you saying that maybe even a real estate broker is a dual trader or an insurance agent or a banker?

Mr. MAHLMANN. They all can be.

Mr. TALLON. How many people do you have authorized to trade on the Chicago Board of Trade now?

Mr. MAHLMANN. Congressman, we have approximately 3,500 members.

Mr. TALLON. What percentage or how many of those 3,500 members are actively participating or are qualified dual traders?

Mr. MAHLMANN. I cannot give you an accurate number on the number of members. I can give you an estimation of preliminary results of trading volume that occurs on our exchange that is done by dual traders. As I indicated, it is preliminary, but it looks like it could be as much as 20 percent of our volume of contracts that are traded on the exchange could be done by brokers that also trade for their own account.

Mr. TALLON. To your knowledge, how many times has the Justice Department brought criminal penalties against any floor traders on the Chicago Board of Trade for specifically trading ahead of a customer?

Mr. MAHLMANN. I would have to ask my general counsel because I do not know of any.

He is not aware of any, either.

Mr. TALLON. How would you view this legislation if criminal penalties were included in for trading ahead of a customer?

Mr. MAHLMANN. Congressman, the exchange right now has within its rules a prohibition of trading ahead of a customer order. I think it is up to this committee if it elects to include that into the act. We have that as a rule already.

Mr. TALLON. Thank you. My time is up.

Mr. ENGLISH. Ms. Long.

Ms. LONG. Thank you, Mr. Chairman.

Mr. Mahlmann, in your testimony, you indicated that the CFTC came to the same conclusion that you came to, that the board came to at approximately the same time on July 11.

Why do you think that the board is better equipped to identify a potential emergency or real emergency and then to follow through with the execution of an emergency order—better equipped than the CFTC?

Mr. MAHLMANN. The board and its staff are living within the market place everyday. The Board of Trade staff is monitoring all the activity of every market participant, particularly so in an expiring option. The business conduct committee is in constant contact with the office of audits and investigations of our staff, and I think their expertise—that is their livelihood—lends them a better insight or a better feeling or a better knowledge and prognostication of whether we have a potential default on our contract or not or whether we have right now a potential, very upset liquidation process in the contract.

I feel strongly that the members of the exchange that are part of that committee to monitor that, who have been delegated to do so are the best equipped to do so. They come out of the industry.

Ms. LONG. How do you address the concern regarding objectivity that the CFTC is a more objective body than the board?

Mr. MAHLMANN. As I indicated before, there is a requirement, every business conduct committee member has to adhere to an oath of secrecy, every business conduct committee member is asked prior to any meeting whether he has an involvement in a particular contract if that is up for discussion. He is asked to recuse himself, and I believe every business conduct committee member as well as every board member who goes through the same procedure and has to disclose whether there is a conflict of interest.

I think that is established beforehand so that you have absolute impartiality. I think it occurred in this instance. I can state for this committee that the opening question that I ask every board member when they came to the deliberation—when they were called for that meeting before the issue of the day was put before them, before any proposal was discussed, the opening question was, "Do you own or control any July bean futures?"

One party answered in the affirmative. That party was immediately recused. The rest of the board members in attendance all answered in the negative.

In addition, prior to going into the board meeting, through the office of audits and investigation, did I know, and as the only party that knew whether anybody had any July bean position as of the close of Monday night. And in addition going into the board meeting, I was the only party that knew that the CFTC was arriving at an independent decision that orderly liquidation was jeopardized before I asked the question of every board member whether they had a position or not.

Mr. NAGLE. Would the gentlelady yield?

On the question of the conflict, could I just simply ask for my own education. You indicated you inquired of the board members whether or not they had any interest, any, to quote you, "owned or controlled any positions in July soybeans," I am curious to know whether or not the members of your board would have an interest or serve on the board of any other company who had a position on July soybean futures?

Mr. MAHLMANN. The question that I asked, do you own or control, and if they answered either of those parts with no or both of those parts no——

Mr. NAGLE. Did any of the members present in the room that voted on the decision hold a position with any of the companies or brokerage houses or agencies that would have had a position of July soybean futures? I mean, for example, do you have any member serving on your board who is also a member of Cargill, the board of directors of Cargill? That type of situation? I am not saying that they do, I am just inquiring.

Mr. MAHLMANN. I said every member that was there answered in the negative when I asked him do you own or control. If you are representative of a futures commission house and you have customers potentially, he did not own or control the position of those customers that may clear through you as a futures commission house. That is not a disqualification standard.

Mr. NAGLE. That is my question. You mean I could serve on the board and make this decision and also be a member of a brokerage house who had customers that had positions that would be adversely affected or enhanced by the decision that I was going to vote on?

Mr. MAHLMANN. That is correct.

Mr. ENGLISH. The gentlelady's time has expired. The gentleman is next to be recognized, but I think we better go vote. Maybe the gentleman would like to recognize the lady in case she has another question since her time expired.

Ms. LONG. No, thank you, Mr. Chairman.

Mr. ENGLISH. Thank you very much. We will recess for this vote.

[Recess taken.]

Mr. ENGLISH. The meeting will come to order. Mr. Nagle.

Mr. NAGLE. How many members are there on the board?

Mr. MAHLMANN. Twenty-four.

Mr. NAGLE. Is Hal T. Hanson a member of the board?

Mr. MAHLMANN. Yes, he is.

Mr. NAGLE. And he is the president of Cargill Co.?

Mr. MAHLMANN. He is president of Cargill Investor Services.

Mr. NAGLE. Is that a corporation or a close corporate relationship to Cargill itself?

Mr. MAHLMANN. I do not know the exact corporate relationship to Cargill.

Mr. NAGLE. Anybody there know?

Mr. GREDE. I believe it is 100 percent owned by Cargill.

Mr. NAGLE. Silas L. Hathias, Sr.—is he a member of the board?

Mr. MAHLMANN. Yes, he is.

Mr. NAGLE. Let me be fair. First of all did Mr. Hanson recuse himself from the vote?

Mr. MAHLMANN. No, he did not.

Mr. NAGLE. Silas L. Hathias, Sr.—is he a member of the board?

Mr. MAHLMANN. Yes, he is.

Mr. NAGLE. I have him as the director of grain operations, General Mills?

Mr. MAHLMANN. I presume that is his correct title.

Mr. NAGLE. Did he recuse himself from the board?

Mr. MAHLMANN. No, he did not.

Mr. NAGLE. It would appear to me that there were a number of people—who recused themselves?

Mr. MAHLMANN. One local trader that had 1 minute open position on a spread basis between the Mid-America Commodity Exchange and the Board of Trade. He recused himself.

Mr. NAGLE. Donald G. Andrew is a member?

Mr. MAHLMANN. Yes, he is.

Mr. NAGLE. And he is the senior vice president with Shearson-Lehman and Hutton?

Mr. MAHLMANN. Yes, he is.

Mr. NAGLE. John F. Benjamin, senior vice president for Drexel and Burnham?

Mr. MAHLMANN. Yes, he is.

Mr. NAGLE. Gary K. Biefelt—he is with Biefelt and Co.?

Mr. MAHLMANN. Yes, he is.

Mr. NAGLE. It looks to me like people who work for Shearson-Lehman, Drexel, and Burnham, Biefelt and Co., Index Futures Corp. Group, Inc., Hollander and Ferhagen—I believe it is—Seay and Thomas, Heinweiber, General Mills, Solomon Brothers, Hager Green Co., Triple Nickel Trading Co.—all of these people's companies would have been affected if they held positions by the decision that the board took; would that be fair?

Mr. MAHLMANN. Congressman, as I indicated before, my opening question was: Do you own or control? And all of those gentlemen answered in the negative, except one as I indicated in prior testimony.

Mr. NAGLE. But you did not ask the question: Are you employed by someone who owns or controls?

Mr. MAHLMANN. No, I did not ask that question.

Mr. NAGLE. So if you go back to the question I immediately stated previously, people who made this decision were people who worked for companies, if those companies held the position in the July futures who would have been adversely affected or enhanced by the decision that the board would take?

Mr. MAHLMANN. All of those gentlemen made the statement I have no conflict of interest in deliberating the issue.

Mr. NAGLE. I will ask the question again. People who had employment with companies that if they held futures positions on the July soybeans, they would have been enhanced or diminished by the action of the board, voted on the decision that was taken by the board that day; is that not true?

Mr. MAHLMANN. No, that is not true.

Mr. NAGLE. Then I guess if you are working for Cargill, and your company does not have any—or to be precise, if you worked for a company that is 100 percent owned by Cargill—and I do not mean to pick on Cargill because I have a statement from them here I will get into—but if you work for a company that is 100 percent owned by Cargill, and Cargill could not fill its July futures position, that would not be on the Board of Trade regardless of conflict?

Mr. MAHLMANN. I do not understand the question, Congressman.

Mr. NAGLE. If you are an employer it is good to benefit by the decision you made. Would that not have been a conflict?

Mr. MAHLMANN. I think we have to go back again to the original question I asked. Do you own or control, and that was answered in the negative by each participant.

Mr. NAGLE. But you did not ask the question, are you employed by someone who owns or controls?

Mr. MAHLMANN. No, I did not ask that question.

Mr. NAGLE. Nor did you ask the question, or are you associated with an investment house whose customers own or control?

Mr. MAHLMANN. No, I did not ask that question either.

Mr. NAGLE. Tell me why working for someone who had a position would not have been a conflict to make this extraordinary decision that the board made?

Mr. MAHLMANN. If I pick on my fellow board member Don Andrew who happens to be the vice president of Shearson that you mentioned. Shearson may have customers in July beans, but he neither owns or controls any portion of those accounts and as a board member he can, because he has no conflict of interest and his customers may both be long and short and he may not know who they all are and what they have in positions. He is in a position to make by his expertise as a member of the exchange without conflict that he can make a decision.

Mr. NAGLE. The question I asked, I think, frankly, saying it is not a conflict does not define the fact that there is a troublesome aspect to the board members that made the decision on behalf of companies for which they were employed whose interest may have been impacted by the decision that they were about to render.

Who won and who lost as a result of the order?

Mr. MAHLMANN. I do not think there is one party that won; I do not think there is one party that lost. The order that was established was equal across the marketplace. It applied to both longs and shorts.

Mr. NAGLE. You would not disagree with me that Ferruzzi lost big?

Mr. MAHLMANN. I would disagree with you.

Mr. NAGLE. Please tell me why?

Mr. MAHLMANN. I would first make a statement that the whole marketplace in itself won by the exchange taking firm, independent action that there is no party by themselves that on either side of the marketplace that can be influencing the market.

Mr. NAGLE. I do not mean to quarrel, but let me refine it. Then who suffered a financial loss as a result of the board's action? Would Ferruzzi be one of those people that suffered an immediate negative financial impact as a result of that?

Mr. MAHLMANN. Congressman, we are also in a potential lawsuit that is still pending before Judge Zagle in Federal court in Chicago waiting for amendments. I cannot make a comment right now whether Ferruzzi lost money or not lost money.

Mr. NAGLE. Can you tell me whether or not Ferruzzi is suing you?

Mr. MAHLMANN. They are suing us.

Mr. NAGLE. Can I draw a fair conclusion, although you could not tell me that if they are suing you they are probably not very happy?

Mr. MAHLMANN. I presume you can draw that conclusion.

Mr. NAGLE. How much are they suing you for?

Mr. MAHLMANN. It has not been specified. They have been given a date by which time they can amend their lawsuit.

Mr. NAGLE. Could you provide for the committee a list of those individuals and organizations and business entities and corporations and brokerage houses that benefited financially by the decision of the board, and those that suffered a negative impact as a result of the decision of the board?

Mr. MAHLMANN. Congressman, I cannot provide that list to you because I cannot quantify who won and who lost.

Mr. NAGLE. The board does not have the resources or the information or the capability to generate that type of information?

Mr. MAHLMANN. Congressman, I do not have that information nor does the board.

Mr. NAGLE. Incredible.

Mr. ENGLISH. Mr. Gunderson.

Mr. GUNDERSON. Thank you, Mr. Chairman. Just one quick follow-up question in regard to Mr. Nagle's questioning. Mr. Andrew, when the question was asked whether you own or control, the answer was in the negative. Are you or is any other member of the board aware to the extent to which your company controlled when decisions like this were made?

Mr. ANDREW. I cannot speak for the other companies. I know in my own particular case, I am not privy to, in my position, I am the manager of the floor of the execution of the orders. I am not involved with the individual accounts and what their positions are, so I answered the question.

Mr. GUNDERSON. Is there some kind of confidentiality requirement at a time a decision is made and announced which prevents, what we would call lead information or inside advantage?

Mr. ANDREW. Yes, there is. I wear two hats. One is the Board of Trade hat and the other is with the Shearson-Lehman-Hutton, and they do not overlap. They are separate issues and I personally make it a point that I do not get involved into the position where I would have to compromise my position with the Board of Trade. So they are both separate.

Mr. GUNDERSON. Let me change the focus of the question a bit, because one of the issues that I think presents the greatest challenge to us in the reauthorization and the preparation for the future, especially if we do this in terms of a permanent authorization is the whole issue of international exchange or regulation. You indicate in your testimony that there has been a foreign futures exchange that now accounts for 30 percent of the total futures volume. I assume you mean volume here, or do you mean volume worldwide?

Mr. MAHLMANN. International volume.

Mr. GUNDERSON. What percent of that is American participation do you believe?

Mr. MAHLMANN. I can answer that for the Board of Trade. I cannot answer that for all exchanges. The Board of Trade domestically in the U.S. industry last year represented about 48.5 percent of the industry volume. That was after 4 years of unprecedented growth, cumulatively about 92 percent that the Board of Trade had grown over one 4-year span or the most recent 4-year span. During the same 4-year span with that kind of a growth figure, the Board of Trade's international market trade, meaning of total futures volume worldwide, declined from about 37 to 33 percent.

Mr. GUNDERSON. Can you give me your insight as to whether you believe that was a lack of particular products on your exchange or issues on your exchange as opposed to how much of that might be the result of competitive disadvantage due to regulation? Can you give me some insight on the two?

Mr. MAHLMANN. It is part of both, Congressman. As I indicated in my testimony, for instance, the U.S. Treasury debt instrument is probably the most worldwide spread held instrument substantially in Asia as well as in Europe. Europe already is trading a U.S. Treasury bond contract on the London Futures Exchange. Tokyo intends to bring it up this fall. Both ends are trying to make an end road in what used to be solely our product.

Mr. GUNDERSON. To what degree can you blame that on regulation? And if so, can you be specific as to the regulations now in effect which you believe put the American exchanges at a competitive disadvantage?

Mr. MAHLMANN. I can give you a recap of a very recent conversation with one of the governors of the Bank of England. And we talked about the legislative environment and I told him that in the foreseeable future, I would have to come before this committee to talk about dual trading, and the gentleman said, in London we call it single capacity and we used to be on that standard. But we recognize that the added capital that dual capacity can bring to a marketplace is very much wanted because it creates a better depth and liquidity in the marketplace. It creates closer bid and ask spreads, and it appears to me that we are going the opposite way than the U.S. industry is going.

Mr. GUNDERSON. Do you know of any foreign exchange that bans dual trading or regulates it?

Mr. MAHLMANN. I do not know of any. There may be some, but I do not know of any.

Mr. GUNDERSON. I guess my time is up. Thank you, Mr. Chairman.

Mr. ENGLISH. Thank you, Mr. Gunderson. I have noticed there that the chairman of the full committee has joined us, Chairman de la Garza. Mr. Chairman, do you have any comments or questions?

The CHAIRMAN. Thank you, Mr. Chairman. I will yield my time to the members of the subcommittee.

Mr. ENGLISH. Thank you very much, Mr. Chairman. And we also have the chairman of the Wheat, Soybeans, and Feed Grains Subcommittee. He has something of interest on the soybean issue, I understand. Chairman Glickman, I would be happy to recognize you for any questions you may have?

Mr. GLICKMAN. Thank you, Mr. Chairman, for allowing me to be here. I want to ask you how can a major participant in the market acquire such a large position as Ferruzzi apparently did—how do you monitor that to determine if they are in fact possessed of a legitimate hedging position. For example, I understand that the spec limits on soybeans was what?

Mr. MAHLMANN. Three million bushels per month.

Mr. GLICKMAN. Three million bushels per month and at least it was reported that Ferruzzi stated in Federal court—they had a long position equivalent to 23 million bushels of soybeans. And according to the Wall Street Journal today, this company is at war with you. I am not sure who declared war against whom, but I guess what concerns me is that how do you make a legitimate determination as to whether a company is a legitimate hedger? And do you consider a company that is at war with you a legitimate hedger on your market?

Mr. MAHLMANN. Congressman, no comment on the war. On the other part of the question, Ferruzzi company and its affiliated companies are wholly owned companies, meaning Central Soya processing companies as one of them collectively go to the CFTC to seek an exemptive status from the speculative limits and the CFTC grants a hedge exemption to commercial market participants. And under the exemptive procedures, the CFTC approved the hedge exemptions for the Ferruzzi companies.

Mr. GLICKMAN. So not only did you approve it, but CFTC approved it, right?

Mr. MAHLMANN. Congressman, it is not in the Board of Trade's purview to approve hedge exemptions for grains. We requested that approval process on an emergency basis during the early part of June. We have it on an emergency basis for approximately another 45 days, but the approval to establish these positions was done to the best of my knowledge prior to us having this hedge exemptive procedure approval ourselves for a very short limited time, and the positions that we are talking about were approved under the Commission's hedge exemption.

Mr. GLICKMAN. OK, just so I am clear because I am getting confused now. Who gave Ferruzzi a hedge exemption to go above 3 million bushels of soybeans?

Mr. MAHLMANN. The Commission.

Mr. GLICKMAN. When did they do that?

Mr. MAHLMANN. I do not know a date.

Mr. GLICKMAN. Is it monitored continuously?

Mr. MAHLMANN. Congressman, you would have to ask the CFTC because this is hedge exemption granting which is totally delegated to the Commission. This is for grains.

Mr. GLICKMAN. Let me move off of this one for a moment. In your statement you state that no trade will escape the exchange's computerized microscope. That is a quotation from your statement.

Does that mean that you will be able to determine with absolute precision who is dual trading?

Mr. MAHLMANN. It means that we are, under our surveillance microscope, auditing and reviewing 100 percent of every trade that occurs. Can we under that determine who trades for their own account and for its customer orders? Yes, we can.

Mr. GLICKMAN. Will you be able to? See the implication of your statement is that you will be able to determine with pretty much an absolute certainty who is dual trading, who is not, and then make the appropriate judgment. Is that a fair assertion?

Mr. MAHLMANN. That is a correct assertion.

Mr. GLICKMAN. At the current time, can you determine who is dual trading?

Mr. MAHLMANN. Yes, we can.

Mr. GLICKMAN. Do you know how many traders are, in fact, trading for their own accounts, as well as for customer's accounts right now?

Mr. MAHLMANN. I do not have the number, but I may be able to give you the number of our membership. No, I do not have it handy.

Mr. GLICKMAN. I think that would be useful. Let me just ask you a couple of other quick things. SWAPS, you make the point that the CFTC has basically approved SWAP trading in kind of an unregistered fashion, so you can have dual trading on SWAPS. Are you recommending that we in fact regulate SWAPS as futures?

Mr. MAHLMANN. I strongly recommend, first of all, that SWAPS be declared futures contracts. And that they fall under this committee's jurisdiction and under the jurisdiction of the Commission. So the answer is yes all the way through.

Mr. GLICKMAN. The final question goes to the number of—let me just mention one quick thing. I think the point of Mr. Nagle's question about—did any of the people who were on your board work for other companies that might have had positions—I think it refers to the fact that it was clear that a decision by the board to close out these long positions would result in a significant reduction in the market price—soybeans?

Mr. MAHLMANN. No, it was not clear. The order of the board applied to both long and short hedgers that had in excess of 3 million bushels. It therefore affected also parties that had to cover short positions.

Mr. GLICKMAN. Once a hedge exemption is granted, do you ever monitor the position of a hedger to determine how big the position gets?

Mr. MAHLMANN. We monitor positions constantly.

Mr. GLICKMAN. Thank you, Mr. Chairman.

Mr. ENGLISH. Thank you. Mr. Coleman.

Mr. COLEMAN. Let me ask a question about the spec limits that CFTC provided an exemption on in this particular case; is that correct?

Mr. MAHLMANN. That is correct.

Mr. COLEMAN. The usual limit is 3 million bushels?

Mr. MAHLMANN. That is the speculative position limit that any one speculator in the United States can hold in a single contract month.

Mr. COLEMAN. Unless they receive some sort of an exemption from the Commission?

Mr. MAHLMANN. That is correct.

Mr. COLEMAN. You know when they received this exemption?

Mr. MAHLMANN. No, I do not.

Mr. COLEMAN. Were you knowledgeable of this exemption?

Mr. MAHLMANN. Yes, we were.

Mr. COLEMAN. You were informed or you just heard about it? Did the Commission inform you?

Mr. MAHLMANN. The Commission did not formally inform us. They were permitted to carry that position.

Mr. COLEMAN. Do you think that there should be some sort of rule or requirement that you be notified of that?

Mr. MAHLMANN. Congressman, I think the Board of Trade action, as I indicated before to Congressman Glickman from Kansas, was that the Board of Trade in emergency action requested to have the jurisdiction over agricultural spec limits. We did so in early June. We got permission or our request was granted on an emergency basis and will expire roughly in 45 days. Yes, the exchange felt strongly that the exemptive procedure should also be within the hand of the exchange.

Mr. COLEMAN. I am sorry I had to step out of the room, I did not hear what you were saying.

Mr. MAHLMANN. I am sorry.

Mr. COLEMAN. I am glad you mentioned it. So the CFTC granted you some extraordinary emergency——

Mr. MAHLMANN. Only under our emergency request were we granted the exemptive procedure as an exchange, but I strongly believe we should have that power concurrently with the Commission.

Mr. COLEMAN. How common is it to receive one of these exemptions from the Commission?

Mr. MAHLMANN. Any commercial user showing justifiable reason of why they would have to exceed the speculative limits can go to the Commission and get approval.

Mr. COLEMAN. Is it not common knowledge that the amount of available soybeans was considerably less than 23 million bushels?

Mr. MAHLMANN. It stipulated in cart that the amount of deliverable supplies within the deliverable contract area attributable to the futures contract on the Board of Trade was approximately 10 to 12 million bushels which were predominantly owned by the same party that owned the futures contract.

Mr. COLEMAN. Knowing this as a fact, not as a judgment, the CFTC allowed this exemption to occur knowing that the contracts could not be fulfilled. Is this an unusual conclusion that one would draw if one knew the supply and knew the position to allow an exemption?

Mr. MAHLMANN. I think the answer would be no, because normally you would expect orderly liquidation of the contract.

Mr. COLEMAN. Let me ask a line of questions about the recusing from the discussion that the board of directors had on July 11, and ask you that if a company has a large position apparently as one did and in a market like this, is it generally known on the floor that this is occurring? Is this exemption that was granted by the Commission a matter of public record?

Mr. MAHLMANN. It is not a matter of public record.

Mr. COLEMAN. But generally speaking, do people sense and pick up the action that there is such a position being held? Would you say this was common knowledge?

Mr. MAHLMANN. By coffee shop talk, I would presume so.

Mr. COLEMAN. And people on the floor would definitely fall into that category?

Mr. MAHLMANN. I would think so.

Mr. COLEMAN. So my question would be—and I am not suggesting that there is or was any wrongdoing—as we look at self-regulation and the questions that one raises with the potential conflict of interest, this was common knowledge that people could benefit one way or another having this knowledge, notwithstanding that they may have answered your question about having an interest or control on a particular date. Leading up to that date people could have, because of this common knowledge, participated in the markets in some fashion that would have benefited themselves. Is that possible?

Mr. MAHLMANN. Congressman, I do not understand the conflict. I can make one statement. The only one, the sole member of the board, other than the president who is a nonvoting member, that knew about the proposal that may go to the board for discussion without knowing how it would come out was myself.

Mr. COLEMAN. I understand that. But it is possible that people not only on the board but other people who were traders could have—with this understanding of what was going on in the markets—obviously tried to benefit from it or reduced their exposure in the weeks leading up to a decision on July 11?

Mr. MAHLMANN. Congressman, I cannot comment on traders that react to rumors and take positions on the rumors.

Mr. COLEMAN. Is there any reason why members of the board of directors would be in any better position to gain or to lose than any other person who was on the floor?

Mr. MAHLMANN. No. Absolutely not.

Mr. COLEMAN. And in this particular question, since the CFTC had already made a concurrent decision, even absence the board making a decision, the effectiveness of that decision would have been the same in this particular instance. If CFTC had not taken that action then there may have been more reason to feel that a conflict of interest that one may have worked for an employer who held a position would have been more meaningful. This particular case was less so probably because the Commission had made a similar decision.

Mr. MAHLMANN. Now the CFTC came to the same conclusion as the board, but there existed a problem in the orderly liquidation of a contract. The two entities came to that conclusion independent of each other.

Mr. ENGLISH. Mr. Nagle.

Mr. NAGLE. I want to go back again. Mr. Andrew, you are a senior vice president with Shearson-Lehman and Hutton, Inc.?

Mr. ANDREW. That is correct.

Mr. **Nagle**. Was Shearson-Lehman and Hutton giving advice to customers as to whether it would be prudent or not in May and June to invest in July soybeans? Does your company give that kind of advice?

Mr. **Andrew**. I am sorry, I did not hear the question. Let me see if I hit it. Does my company give advice to buy or sell July soybeans?

Mr. **Nagle**. Yes.

Mr. **Andrew**. They give advice on the soybean market. It could be July, November or any, yes.

Mr. **Nagle**. Would the same be true for Drexel, Burnham, and Lambert? Would they render basically in the industry the same kind of advice that July futures are a good buy or July futures are a bad buy?

Mr. **Andrew**. Generically, most of the firms will have analysts in beans and they are given recommendations to buy and sell for all markets. When I say all markets, I mean all markets, not just soybeans but grains and also with soybeans, July, old crop, new crop, that type of thing.

Mr. **Nagle**. Would it be fair to say that Shearson-Lehman would have customers who would have been affected by the decision that the board took on, I believe, it was July 11?

Mr. **Andrew**. I do not know what the Shearson positions were, the customers positions were. I assume that they could have been on both sides. So I do not know, some could be winners and some could be losers.

Mr. **Nagle**. Could the same be said for Drexel, Burnham and Lambert?

Mr. **Andrew**. I really cannot speak for Drexel.

Mr. **Nagle**. The board is composed of 24 members. How many of them are independent members or public members?

Mr. **Mahlmann**. We have three nonmembers, meaning nonmembers of the exchange on our board. That is from the general public. There are three members who are members of the exchange but are members from outside of Chicago. They are nonresident members. There are eight members and members of the exchange who are currently principals or officers of Futures Commission Merchants. There are six directors whose principal occupation in life is being brokers on the exchange. And there are three members whose principal activity is to trade for their own account. In addition to that you have the president who is a nonvoting member of the board.

Mr. **Nagle**. Can you obtain and supply to the committee the open positions of all participants in the July contracts of soybeans at the end of each day from July 11, to last night?

Mr. **Mahlmann**. Congressman, under proper subpena, we will be very happy to supply the committee with the records of anybody in the marketplace on July 11.

Mr. **Nagle**. And can you obtain and supply to the committee the trades by all participants for each day from July 12 through noon today?

Mr. **Mahlmann**. Under the proper subpoena, we can supply that to the committee.

Mr. **English**. Would the gentleman yield?

Mr. **Nagle**. I would yield to the chairman.

Mr. **English**. On this particular point, it may be more proper for any requests that are made to be made through the CFTC. The law is quite clear as to the committee's right to information. And as I understand it, the CFTC then has the right and access to all the information that is in question. So as opposed to the committee going directly to an exchange, it may be more proper for us to go through the CFTC and perhaps the committee might want to get together and discuss what information—let me say this. There is already a request before the CFTC, and it is my understanding that this subcommittee will be supplied certain information. Perhaps we should review that information and determine if we need any additional information, but some of it is along the lines you are talking about, Mr. Nagle.

Mr. **Nagle**. I would like to make that a formal request of the committee, but I will defer until we have a chance to talk, Mr. Chairman. But I think probably, I would like to make a formal motion, if necessary.

Mr. **English**. Thank you very much.

Mr. **Nagle**. When Dr. Gramm was here, I am almost certain and I will have to review her testimony precisely, but I am almost certain that she told me that the CFTC did nothing when informed of the board's decision, except thank you for the information. I am just dead certain. I am quoting from a newspaper article that says——

Mr. **English**. What paper?

Mr. **Nagle**. The Journal of Commerce quotes her at the hearing as saying, as to the House Agriculture subcommittee hearing on reauthorization of the CFTC about her reaction to CBT's notice. She said, "she thanked them for the information." I thought your testimony today was as if the CFTC took an independent step or action other than just simply thanking you. Your testimony is that they—what did they do?

Mr. **Mahlmann**. Congressman, the Commission took independent action vis-a-vis one market participant by revoking the hedge exemption of that market participant, effective the close July 18 which in effect meant that that market participant had to liquidate whatever they had open, single market participant, up to and inclusive July 18, down to 3 million bushels.

Mr. **Nagle**. So if the committee were told that CFTC did nothing, that testimony would have not been consistent with your recollection?

Mr. **Mahlmann**. The CFTC took their own independent action. The Board of Trade did its own independent action. We communicated those actions to each other.

Mr. **Nagle**. With the indulgence of the Chair, you started monitoring this in May as a board?

Mr. **Mahlmann**. The July contract was started to be monitored last week of May, first week of June, after the May contract had gone off the board.

Mr. **Nagle**. Did you monitor it every day?

Mr. **Mahlmann**. On a daily basis.

Mr. **Nagle**. And the price continued to rise?

Mr. **Mahlmann**. I do not recall any price movement in particular during the time from May on forward. It was irrespective of the price movement. We monitored open positions every day.

Mr. **Nagle**. I guess I am curious. Would you agree that there was an upward trend in the price on July soybean futures between——

Mr. **Mahlmann**. I do not recall the prices, Congressman.

Mr. **Nagle**. Could you supply that to me?

Mr. **Mahlmann**. Yes, we can.

Mr. **Nagle**. The question I want to know is: Why did you wait so late before you finally took the action?

Mr. **Mahlmann**. Congressman, you are most reluctant as an overseer of orderly markets to declare that there is an emergency. And you hope that all market participants will live within their obligation to affect orderly liquidation. Emergencies are only taken as a last resort.

Mr. **Nagle**. I would characterize and I would ask you to assume for the purposes of my question. The characterization of this appears to be an attempt at marketplace manipulation by one of the market participants.

I want you to make that assumption. Do you anticipate at the CBOT that in the future you will see more of this type of market manipulation activity or to put the question neutral, more of this type of market conduct?

Mr. **Mahlmann**. I cannot comment or would I even speculate whether there would be more manipulation. I cannot comment on any potential allegation of manipulation to begin with. All I can say is that the procedures in the May contract by jcb owning the market participants, both long and short, got us a reasonable—even though only by the skin of our teeth, orderly liquidation. That same system failed in July. Therefore, the emergency action.

Mr. **Nagle**. Are we going to see more of these in the future?

Mr. **Mahlmann**. That is speculative and I hope not.

Mr. **Nagle**. I hope not too. In terms of the reauthorization of the CFTC, are there any steps this committee could take to see that perhaps you can act expeditiously when confronted with this situation or the CFTC can act expeditiously when confronted with this situation, assuming that it does reoccur?

Mr. **Mahlmann**. We strongly hope it does not reoccur. And that the action that we took is strong enough to the participating world whether long or short, that the Board of Trade will not stand for a single party pushing the marketplace in total around.

Mr. **Nagle**. You do not have to answer this today, but you are not requesting any additional tools to deal with this situation should it reoccur?

Mr. **Mahlmann**. Could you repeat the question, please?

Mr. **Nagle**. I am trying to get the sense of direction of how we can deal with these things in the future, if they do happen, and I share your hope that they do not. And I am asking you whether or not you think that in the process of our reauthorization, there are any additional tools that either you or the CFTC should have legislatively?

Mr. **Mahlmann**. Congressman, as I indicated before, I think the exchange would like to have cojurisdiction over the exemptive process of speculative limits, but other than that, I think there are good checks and balances in place between the self-regulatory environment of the exchange and the regulatory environment of the Commission.

Mr. NAGLE. Is the exchange, the Board of Trade given any consideration in light of the composition of the board and this situation specifically? Is the board given any consideration to expanding its public membership?

Mr. MAHLMANN. We have given it consideration.

Mr. NAGLE. That narrows it down, for or against it?

Mr. MAHLMANN. I would be speculating right now as a single member of the board. But it would be my idea to expand the board by one nonpublic director. I mean, public director.

Mr. NAGLE. Thank you, Mr. Chairman.

Mr. ENGLISH. Thank you very much, Mr. Nagle. Mr. Holloway.

Mr. HOLLOWAY. No questions. Mr. Mahlmann, I want to thank you very much for your appearance before the subcommittee. It has been very helpful and I think that without question, the information that you provided concerning the soybean situation is most helpful as well. That is a subject of great interest and particularly this subcommittee has taken note of and I think it certainly has gotten the attention of a lot of members of this subcommittee that the question of the involvement of the CFTC. I think we were led to believe on Tuesday that the situation occurred differently than what you told us and we plan to look into that very carefully and further. So I am sure we will have an explanation from the Chairman of the CFTC. Thank you very much.

Mr. MAHLMANN. Mr. Chairman, I would like to thank you for scheduling us after the expiration of July futures and I would like to thank the staff that worked diligently and has been very much available to have dialog with. Thank you very much.

Mr. ENGLISH. We are looking forward to continued dialog, and as I said as we talked about earlier, as far as the legislation is concerned, I think we are talking about degrees in many areas. And we are looking forward to resolving those matter. Thank you very much.

Our next witness is James Lindau who is president of the Minneapolis Grain Exchange in Minneapolis, Minnesota. Mr. Lindau, we appreciate your coming and I know that you have been waiting very patiently and we are looking forward to your testimony. As I told our other witnesses if you would care to summarize your testimony, please feel free to do so, and without objection it will be made a part of the record.

STATEMENT OF JAMES H. LINDAU, PRESIDENT, MINNEAPOLIS GRAIN EXCHANGE

Mr. LINDAU. Thank you very much, Mr. Chairman. I must say this has been an interesting day. I am James Lindau, president of the Minneapolis Grain Exchange. I am delighted to have this opportunity to talk to you. There are a lot of things that are on the table before us that are very important. I am going to try to restrict myself to a very few.

The Minneapolis Grain Exchange was established in 1881. It is an active cash grain trading center and maintains futures contracts and options on Hard Red Spring wheat and contracts only on White wheat, oats, and high fructose corn syrup.

I note that representatives from several other exchanges have already testified before this committee in connection with this year's CFTC reauthorization. Let me limit my remarks to the issues of major concern to the Minneapolis Grain Exchange.

First, a general comment. I am a newcomer in representing an exchange in a setting such as this, but I am familiar with business and government. I spent 23 years with a company that will remain unnamed, as a manager of grain trading and a feed ingredient trading business, and 11 years as mayor of the third largest city of Minnesota.

The futures industry today with all its size, strength, and variety owes much of its growth and credibility to the action of this committee in 1974. In that year you crafted legislation to create an exclusive, independent regulator to regulate the Nation's futures markets. The child of that legislation, the Commodity Futures Trading Commission, has done a good job under difficult circumstances. However, we are concerned that parts of this bill serve to revive the 1974 mandate and put micromanagement of some aspects of the industry in the Congress and out of the expert regulators. One must question whether this is either good business or good government.

Specifically, dual trading is essential to preserving liquidity in our futures markets. Dual traders are involved in every aspect of futures trading at the Minneapolis Grain Exchange. They cannot be separated from trading in the current option, or spreading against deferred options, and permit retention of any semblance of liquidity.

If dishonesty springs from dual trading, we must increase our vigilance to prevent it, even though there is no evidence of dishonest dual trading at the Minneapolis Grain Exchange. If dishonest dual trading springs from highly liquid, active futures markets, let us identify and punish the dishonest traders, but let us not, in the process, destroy the futures markets. These markets have provided the best, and often the only source of pricing information and margin protection dating back almost to the Civil War.

Technology is reaching the point that very accurate, timely audit information is available to help identify those traders who might try, unfairly, to do better than their trading skill alone might permit. At the Minneapolis Grain Exchange, we believe that our audit program provides a satisfactory means by which to verify the timing data submitted to the clearinghouse and to detect inaccurate or missing trade data on source documents.

In this regard, the Commission, during its 1988 rule enforcement review of the Minneapolis Grain Exchange, found that the exchange's 1-minute timing system was extremely accurate. The CFTC stated, "The exchange's overall accuracy rate was 96.8 percent." We believe that an accuracy rate of 90 percent or greater may be a proper target, and will, of course, continue to strive to maintain a high level of performance in this area. I will add parenthetically that our goal is certainly higher than that.

Let me take 1 minute to congratulate Mr. Cherry and his staff on their professionalism. We were visited at the Minneapolis Grain

Exchange by Mr. McDonald who was competent and thorough. It is our view that the fruits of this long, detailed investigation should be fully used by the committee as part of its responsibilities to overview the CFTC. In the main, the CFTC has more than enough statutory authority in the areas of so-called dual trading, audit trail and composition of boards at exchanges. I think it is entirely appropriate for this committee to review the record of the CFTC on these issues. It would be risky to incorporate your concern into statutory mandates.

[The prepared statement of Mr. Lindau appears at the conclusion of the hearing.]

Mr. ENGLISH. Thank you very much, Mr. Lindau. From what I know of the exchange out of Minneapolis, you do not have a single contract that would fall under the provisions of this legislation, do you?

Mr. LINDAU. That is correct, sir.

Mr. ENGLISH. So it has no impact on you whatsoever?

Mr. LINDAU. At the present time, we have no contract that would reach the limit that you have established. Obviously, we hope that that becomes a problem.

Mr. ENGLISH. But you have a long way to go?

Mr. LINDAU. I can say that with confidence. We have a long way to go.

Mr. ENGLISH. With regard to the point that you made with more than enough statutory authority. I would wholeheartedly agree with you. CFTC does have more than enough statutory authority. And one of the problems we have is that when we find an agency that is not using the authority that they are provided, we have two choices. One, we can attempt to address that problem, namely through legislation, or we can simply accept the fact that that agency chooses not to act. And in this particular case of this legislation, we have chosen to act where we see the failure of the CFTC to act. It certainly is not the desire of the members of this subcommittee or the full committee or the Congress to have to take this action. We would much prefer to sit back and say, gosh you guys are doing a great job and we are thrilled about it and go merrily on our way past the reauthorization.

That is not the case. We have some problems that we are facing. We have an investigation underway by the Justice Department that is well documented. You have just heard much of the controversy with regard to decisions that are being made. We have evident involvement by the Commission. We had Chairman Gramm come before this committee and leading this committee to believe that the CFTC was nothing more than a casual observer who received information.

We do not have much choice. If, in fact, we are going to demand higher standards. That is the real issue we are talking about is whether we are going to demand higher standards. Then we have to take that action. We are soliciting and hoping to work with the exchanges. We want to work with you, and as I mentioned, the Board of Trade and earlier this morning, the Chicago Mercantile Exchange, the New York Exchange, Kansas City, in trying to develop what those standards should be and the best way to reach those standards.

We have had the Futures Industry Association testifying that they agree with us that a carrot and stick approach is necessary if we are going to achieve those goals. That is basically what this legislation contains. It holds out a carrot, but there is also a stick. We recognize that with your audit trail and the system that you have, you are among the top exchanges in the country as far as being able to monitor and make certain that you know when any type of wrongdoing takes place, and we want to push other exchanges to reach those goals.

Mr. LINDAU. Mr. Chairman, yours is not an enviable task. I agree that it is difficult to accomplish. I think you should take some comfort and confidence in the fact that every exchange who has spoken here this morning shares your goal of creating a more honest, more reliable marketplace. So in that, we can all work together.

Mr. ENGLISH. I appreciate that very much and we are looking forward to your suggestions and your thoughts. And I am hopeful that in the next few days that we will firmly establish and detail what those standards will be. So thank you very much. Mr. Tallon.

Mr. TALLON. Thank you, Mr. Chairman. I think you told us that you do not have any contracts on your exchange that would fall into 7,000 contracts a day being traded and therefore come under certain restrictions, but with your audit trail and the technology you are using, are you able to have 100 percent audit trail that can detect any and all abuses? Can you do that?

Mr. LINDAU. Mr. Chairman and Mr. Tallon, as I indicated in my remarks, we had at the last analysis a 96.8 percent accuracy rate; 100 percent would be difficult in only one respect. We time our trading cards to the minute. If there happen to be 1, 2, or 3 trades in that same minute by the same trader, we may not be able to be 100 percent accurate, but we think that even at 96.8 percent, we are pretty close to perfect.

Mr. TALLON. And perfection is pretty difficult to achieve, is it not?

Mr. LINDAU. Of course, it is. It can only be a goal. One of the restrictive factors is the cost of getting to that point of perfection. As an exchange, we can only do what we can afford to do. We are pleased that that has got us to 96.8 percent.

Mr. TALLON. Wait 1 minute. Do you believe that if cost was no problem that you could get to an absolute 100 percent with any and all abuses?

Mr. LINDAU. Mr. Chairman and Mr. Tallon, if costs were no factor, we probably could find a person to stand by each one of our 60 or 70 traders in the pit all day and go home with them at night to make sure the trades were honest.

Mr. TALLON. From a practical standpoint, I certainly agree with the chairman that with his carrot and stick approach, but maybe his stick is too long. I do not know. Thank you.

Mr. ENGLISH. Mr. Holloway.

Mr. HOLLOWAY. We appreciate you bearing with us with the long day we have had. I am sure that you have had interest in the hearing as well as we have. I just basically say with dual trading, do you get many letters in or my perception of what America feels is that it is evil. Do you get many letters to the exchange asking you or questioning you about dual trading?

Mr. LINDAU. Mr. Chairman and Congressman Holloway, we have not had any cards or letters dealing with dual trading. As a matter of fact, the number of customer complaints that we get is very small. Ours is principally a commercial market. Dual trading has not become a household word.

Mr. HOLLOWAY. I have no further questions, Mr. Chairman.

Mr. ENGLISH. Thank you very much, Mr. Lindau. I appreciate your testimony very much.

Mr. LINDAU. Thank you for giving me the opportunity.

Mr. ENGLISH. And as I said, we will be looking forward to working with you.

Our next witness is Dr. Sanford Grossman who is with Princeton University, Princeton, New Jersey.

Dr. Grossman.

STATEMENT OF SANFORD J. GROSSMAN, PROFESSOR, DEPARTMENT OF ECONOMICS, PRINCETON UNIVERSITY

Mr. GROSSMAN. Thank you for inviting me. I am a professor of finance. I have been a professor of finance at Princeton University of Chicago, University of Pennsylvania, and Stanford University. I have worked for the Board of Governors of the Federal Reserve. My research over the last 15 or so years is involved in the study of futures and securities markets with special attention to the determinants of market liquidity and price discovery. My current research involves studying dual trading, as well as the mathematics of transactions, cost avoidance, and securities in futures markets. I have worked for the New York Stock Exchange, Katz and Bachs study of program trading. And I have recently completed the theoretical part of my study of dual trading for the Chicago Board of Trade.

I would like to if I could summarize the results of that part of the study for you. Some of this is going to sound, I am afraid overly academic, but that is where I come from.

From my point of view dual trading is said to occur when an entity sometimes trades as a broker for customers, and at other times trades for its own account. I found that dual trading is quite pervasive throughout the U.S. securities and futures markets, as well as in financial and commodity markets throughout the world. The pervasiveness of dual trading is due to the fact that many of the skills and facilities required to be a good broker are also necessary to be a good trader.

Dual trading increases the supply of both brokers and floor traders because a dual trader can earn income from two activities to cover his cost of training, his exchange seat, and time spent on the floor. He has less idle time and facilities when he can switch from the activity in low demand to the activity in high demand.

I should just mention that as a professor, this notion that you can be spending your time on two different activities and be a dual trader is very common in my business, the professor business, where we both do teaching and we do research. And there is some overlap between the skills required to be a good teacher and the skills required to be a good researcher, and when we do not spend our time teaching, we switch and do research and sometimes if you do research for too long you get a headache and you prefer to do some teaching. So this notion that your skills in trading that one has can be used for two activities is something that every research professor is familiar with.

Returning to dual trading, I found that dual trading has both a direct and indirect effect on the quality of customer services. The direct effect is an increase in the quality and quantity of brokers. The fact that dual trading increases the supply of brokers means the customer has more brokers to choose from and at a lower price. Furthermore, using a broker who is a good trader means higher quality execution for customers.

The indirect effect of dual trading derives from the increase in the liquidity of the market caused by the increase in the number of market makers. Parties who trade for their own account by buying at a low price and selling at a high price serve a market making function. Thus, the ability for an entity to use its facilities for proprietary trading results in an increased presence of market makers on the floor at times when their services are most needed. More traders standing ready to trade make for a more liquid market with smoother price changes.

In order to aid in a comparative analysis of dual trading I distinguish two types of dual trading. The first type called simultaneous dual trading occurs when a firm trades as a principal for its own account, and an agent for its customer in the same transaction. This type of dual trading is prevalent in securities markets, currency and interest rate swap markets, and the fixed income market.

As a matter of fact most member firms of the New York Stock Exchange call themselves broker-dealers. These stock exchange firms sometimes act as brokers, trading for customers as brokers, and other times trade for their house or proprietary account. Every major firm that you have ever heard of that trades stock, trades for its house account and it also trades for customers.

But it does something even more extreme than that. Sometimes it does both at the same time by taking the opposite position of a customer transaction, crossing that transaction, for example, on the floor of the New York Stock Exchange. I heard it said today that specialists are dual traders in the New York Stock Exchange, but that is an understatement. Every major firm that is a member firm of the exchange both trades for its own account and trades for customers. Simultaneous dual trading does not take place in futures markets in the sense that firms do not simultaneously take the other side or their own customers trades.

The second type of dual trading which is something that occurs in our futures markets is what I call consecutive dual trading, and this occurs when a firm trades for customers as an agent and at other times trades for its own account as a principal, but the firm does not do both in the same transaction. Consecutive dual trading occurs in futures markets, as well as in all of the markets in which there is simultaneous dual trading.

Dual trading plays a particularly important role in futures markets as contrasted with securities markets. The fact that all trading in futures takes place on the exchange floor and that spread trading is an important part of hedging strategies make the skills of a trader more necessary for a good futures broker. The immediacy required by the futures markets makes liquidity more important, and therefore makes a larger supply of market makers more critical than it would be in a securities market.

There are three types of brokerage services that I have identified that the customer needs. The first service called search involves searching for the parties who are interested in being on the other side of the trade, that is the contra-side, the contra-party to the trade. The second service called timing involves obtaining and processing information to determine how long to wait for the arrival of the most advantageous contra-party while being exposed to the risk of an adverse price move. The third service bargaining involves actively bargaining among available contra-parties to obtain the best price.

A securities broker can use his skills and sales force to prearrange trades upstairs. Upstairs search in securities markets is often an effective substitute for the downstairs working of an order where timing and bargaining skills are needed. A futures broker cannot prearrange trades upstairs. The brokerage firm cannot substitute search skills for trading skills. The order must be worked on the exchange floor. The floor broker must have the ability to trade in such a way on the floor of the exchange that he brings the other side of the trade to the floor at a good price for his customer. Therefore, floor trading skills are relatively more important in the futures market than in the securities market.

Further, much futures trading involves spreads where a customer wants to buy and sell two or more contracts simultaneously for a guaranteed net price. The customer's broker can execute the spread by trading with a local on the floor, or the broker can execute the individual legs of the spread consecutively. The latter will be in the best interest of his customer if the broker is a skilled trader, since by trading each leg himself, the broker avoids paying the local a premium for the risk in trading the spread. Such spread trading is inherently risky to a broker, since after he executes one leg of the spread his customer can hold him to a price for the other leg of the spread, which the broker may find impossible to achieve if the price moves after he does the first leg. This aspect of futures trades as well as the relatively high underlying price volatility in many futures contracts increase the trading skills burden on a futures floor broker relative to that of a securities floor broker.

Futures trading customers often have a high demand for immediacy because they are trading to hedge an underlying spot market position. The fact that immediacy of trade execution is extremely important to futures customers implies that they will have a greater demand for market makers than will be the case in markets where the cost of delayed execution is smaller. A commodity hedger bears great risk if he does not do his futures trade immediately. This risk may force him to trade using a market order, for example, to sell immediately to the highest bidder currently available. If there are few market makers, then he will receive a relatively low price, that is, his trade will have a high market impact. Thus, futures markets have a great demand for traders who in effect serve a market making function. The institution of dual trading permits this demand to be met at low cost.

Mr. ENGLISH. Dr. Grossman, we have a vote on the floor, we are going to have to make, so we will be back here just shortly. We will have to break for that vote. I am sorry.

[Recess taken.]

Mr. ENGLISH. Dr. Grossman, I am sorry about the vote. We get into these interruptions here as part of our committee process. Please continue with your statement. As I mentioned before, if you care to summarize any of your statement, please feel free to do so. It will be made part of the record.

Mr. GROSSMAN. Yes, I am just about finished. In concluding, dual trading increases the supply of the types of customer services which are relatively most demanded by futures customers. Dual trading is prevalent in the securities market, both on the floor and off the trading floor. Institutional securities trades are often prearranged off the floor, and this lessens the burden of securities floor brokers. It would be quite peculiar to eliminate dual trading for futures and maintain it for securities where the dual trading by floor brokers is less important. The elimination of dual trading from futures markets will harm customers by reducing the quality of brokers who do customer business. The best traders will trade for their own account, leaving customers with brokers who are less skilled traders.

By preventing traders from acting as brokers, the elimination of dual trading will reduce the number of floor traders and thus reduce market liquidity. Foreign markets will gain an advantage over U.S. markets causing large customers to leave U.S. markets, and these U.S. markets will therefore lose liquidity. Therefore, there are small customers who remain and they are the ones who are unable to trade overseas, will be most adversely affected by the loss of liquidity in U.S. markets. Spot markets, such as grains and the U.S. Treasury bond market will be adversely affected by the loss of liquidity in futures markets, and spot prices will become more volatile. Finally, customers will lose the freedom of choice they now have to pick either a broker who trades for his own account, or to pick a broker who trades exclusively for customers.

That is sort of the end of my formal statement. I would just like to give you one example of what goes on on the floor to make you get a feel for what the difficulty is of trading futures sometimes and why futures traders really need a skilled broker. A skilled broker is somebody who is a good trader. Sometimes you have a situation where the commodity or the spread that is to be bought, the bid is $1 and the offer is $1.10. That is a 10-percent spread. Now the customer gives his order to the broker. It could be a market order. If the broker is lazy or very risk adverse, he might just lift the offer to $1.10. Maybe if the broker is energetic and feels likes working hard and taking some risks, he might bid $1.09 or $1.05 in the hope he can get it somewhat cheaper for his customer. Now in bidding $1.05, he of course runs the risk the market will move away from him before he is ever able to get the trade done for his customer. So there is a lot of pressure on a broker about how hard to bargain and how long to wait.

A good broker has to have all the skills of a good trader to give his customer good service. I have listened to a lot of the testimony today and heard about abuses and front running and things that definitely sound terrible to me, but there is one abuse that has not been mentioned which I think economically is at least as great significance, and that is the abuse of a lazy good for nothing broker who does not act by front running adversely to you, but just does not give you a good fill. He goes in and you tell him I have a large size to buy, get me a good price. And he has a big deck; he is very busy; he has a lot of orders to do. He asks what is the market. People give him a very wide spread, as I said, the locals or whoever is there gives him a spread of $1 to $1.10 and rather than bargaining with them and arguing with them effectively and yelling and working very hard to work this order, he goes to the $1.10 and says done. And he has cost his customer perhaps 10 cents. Maybe if he had worked harder, he could have got it for $1, instead of $1.10.

There is a notion that when you give your broker an order, the broker is away from you on the floor and you cannot see how hard he is working that order creates a kind of an abuse of laziness and bad fills, which I think is very significant. And I think, institutions that encourage good traders to become brokers and dual trading is such, the institution of dual trading does encourage good traders to become good brokers and do customer business as opposed to leaving customer business, really lessens what I call the bad fill abuse.

I think in trying to regulate these markets, you should keep in mind that one of the biggest abuses in any principal agent relationship is laziness on the part of the agent and these brokers are agents and anything that can be done to increase competition among brokers by increasing the broker population through allowing dual trading is something that will give the customer a tool to deal with lazy brokers and help the customer get better fills.

That is all of my informal remarks.

[The prepared statement of Mr. Grossman appears at the conclusion of the hearing.]

Mr. ENGLISH. Thank you very much, Dr. Grossman. I appreciate that. I am not sure there is much that this subcommittee can do about legislation on laziness. That is an area we have not had a great deal of success with in the past. There has been once or twice that Congress, I think, has attempted to legislate in that area and it has not worked out well at all. It is my understanding that you have been employed by the Chicago Board of Trade to carry out comprehensive empirical study on dual trading; is that correct?

Mr. GROSSMAN. Yes.

Mr. ENGLISH. Also, it is my understanding you were employed by the Chicago Board of Trade earlier to carry out a study with regard to the proposed 1-minute time bracketing regulations and you put out this booklet; is that correct?

Mr. GROSSMAN. That looks like a reprint of an article published in the Journal of Futures Markets. It is a reprint of a scholarly journal article.

Mr. ENGLISH. Right. You were also employed by the Chicago Board of Trade to carry out that study; is that correct?

Mr. GROSSMAN. I think the study that I did for the Chicago Board of Trade led to that paper. I am not sure they commissure, but there is definitely a relationship, yes.

Mr. ENGLISH. So you were employed to do that. I noticed in this article booklet that it states, "The frequency of dual trading is itself low." And then in another point in there you state, "The frequency of dual trading are worth emphasizing or the low frequencies of dual trading are worth emphasizing." Given that fact, how can dual trading be as vital as it is, since you stated back in 1986, it rarely occurred?

Mr. GROSSMAN. I think, if I remember the context of that is that we were at that time concerned about front running abuses, and that what we did is we studied a particular time bracket. In a particular bracket, we did not find very many instances where a dual trader had both traded for a customer and traded for his own account. That does not mean that across other brackets that particular individual did not switch from becoming a trader, a broker, to a trader who is a proprietary trader.

Mr. ENGLISH. I guess the point that I am making though is that here on one hand you state back in 1986 that this is something that is a low frequency situation. It is something that does not occur that often. If that is the case, I do not understand then why it can be such a big deal this year. The other part of it is that from your testimony, you are talking about a theoretical overview. Does that mean that it has little fact and a lot of rhetoric when we talk about the question of dual trading on your study?

Mr. GROSSMAN. At the moment I have not yet done the empirical part of the study. I have finished outlining the work that needs to be done for the empirical. I do not believe there is any rhetoric here. It is an outline that is a theoretical framework used to provide a guidance as to what should be sought for in the data. Let me just emphasize again and with respect to your previous remark about the low frequency of dual trading, what we said was that the dual trading has a low frequency in a particular bracket. But a given individual who trades in a particular bracket only for himself may in another bracket trade only for customers.

The terms that we have used in the paper that you were quoting, even though that individual across two brackets had engaged in a lot of dual trading in the sense that in bracket one, he had traded only for himself, and in bracket two, he had traded only for customers, in each bracket he had traded only for himself or only for customers. So on a bracket-per-bracket basis, there was not a great incidence of dual trading, but across the whole day there may well have been a large incidence of dual trading. It is the fact that there is not a lot of dual trading within a particular bracket that lessens the occasions where front running abuses can occur.

Mr. ENGLISH. I believe you also stated in the pamphlet that a 1-minute bracketing would constitute regulatory overkill.

Mr. GROSSMAN. Is that a quote?

Mr. ENGLISH. We would be happy to give you the page number, if you would like for us to dig it up for you.

Mr. GROSSMAN. No, I do not remember. I am just asking, are you quoting?

Mr. ENGLISH. No, it is not a direct quote, but that is the context.

Mr. GROSSMAN. I think what we had done at the time was look at the costs and benefits of the proposed regulation and we had used facts to measure those costs, to estimate those costs and facts on dual trading to estimate those benefits. And we have found at that time that the facts were such that the costs seem to be higher than the benefits.

Mr. ENGLISH. And given the fact and certainly given your testimony here today, before you had done the study that you theoretically already support the concept of dual trading. You seem to have some very definite ideas before you had done the study with regard to that. And also given the fact that you have been retained by the Chicago Board of Trade which also supports dual trading, can you tell us that we are going to receive an objective study on this issue?

Mr. GROSSMAN. You should understand that I thought everybody agreed, correct me if I am wrong, that there are potential benefits to dual trading?

Mr. ENGLISH. No, that is not the question. Let me make the point. I do not want you taking off on another angle because basically what we are coming down to, on one hand you come here, you testified you are very strongly in support of dual trading. Two, you have been employed by a firm that strongly supports dual trading, and three, you are telling us you are going to do a study.

It is hard for me to understand how you could have an objective study when you have already reached the conclusion. I do not understand. I am certainly not a Ph.D. and I do not go around doing studies, but it was always my understanding whenever you conducted these studies, you are supposed to be somewhat objective and you are supposed to go and try to learn an answer, not knowing the answer before you went in and then try to prove that it is right.

Mr. GROSSMAN. Even though you are not a Ph.D., I should be articulate enough to be able to explain to you what I am doing and why I am doing it, and I hope you will allow me to do so. This study and the outline that I have given you discusses the benefits of dual trading and how you measure those benefits and where you should look for those benefits. There may well be costs to dual trading and those costs have to do with the abuses that are associated with dual trading. What I think needs to be done to come to an appropriate economic cost benefit analysis is to think of where you would look for the benefits and measure the magnitude of those benefits.

What I have set out to you is where I would look for those benefits. Now the actual numerical magnitude of those benefits are not something one is predisposed toward, they may turn out to be economically negligible. And if certain evidence arises that the abuses are not economically negligible in terms of their costs, then though I have elucidated where those benefits are, the fact that they are sufficiently small relative to the cost would mean that we should restrict dual trading.

So the mere fact that one has from a theoretical point of view said where the benefits would be sought after, does not mean that one is predisposed to the economic, numerical magnitudes of those benefits. I am certainly not so predisposed and I could not off the top of my head even give you a ballpark guess in dollars as to what the magnitude of those benefits are. I should mention to you that there are no studies of dual trading. There are no studies of the benefits of dual trading or the cost of dual trading. I think this is a completely new area and I would urge you to allow studies to go forth to measure the economic quantity of dollar values involved to get a notion of what the costs and benefits are of the quantities being regulated.

Mr. ENGLISH. I am not the one who is paying for it. You would have to talk to the folks who are paying for the study. Thank you very much, Dr. Grossman. We appreciate your testimony.

The next witness is Mr. Warren Lebeck from the National Grain Trade Council here in Washington, DC. Mr. Lebeck, we want to welcome you here today. And as we have told our other witnesses, if you would care to summarize your testimony, the written testimony will be made a part of the record.

STATEMENT OF WARREN LEBECK, ON BEHALF OF THE NATIONAL GRAIN TRADE COUNCIL

Mr. LEBECK. Thank you very much. Well, I am not even going to summarize my testimony. We have submitted a copy for the record, but after being briefed on Tuesday's hearings, I gather that you have heard several times what is in the statement and I do not think that it needs to be repeated, as long as it is in the record. But as a consequence I was advised that the committee might be better served and more interested on comments or questions that it had raised Tuesday, especially on parts of section 101, and with your permission, Mr. Chairman, and respectfully hoping only to be helpful, I would like to give some personal views based on years of observation of this business at close hand.

And I think as you know, and maybe not many people in the room know for me this is deja vu. I do not know that this is the same chair that I sat in, but it is the same place I sat in 16 years ago, and at that time there were questions about why did soybeans go to $12.90 a bushel? You have not heard any prices like that today. And why did the Board of Trade say liquidation only in July futures?

So I have been there and I might say almost reluctantly, I am here again. But just a few views of 35 years of observing futures trading. Banning dual trading at any level means that choices will have to be made and the very real fear is that the best, most competent members will either choose to trade for their own accounts or only for customers who sign releases. And I am going to get to that a little later.

It seems to me that in most instances traders would opt to trade for their own account if they had or if they wanted to have a position. I would hate under those circumstances to be a floor manager because I would have to spend every morning up until that bell rang at 9:30 finding out who is going to fill orders today and who is not going to fill orders today, and I have to wonder if that is the way to assure customers of the best possible service. If there was a monumental news item—Gorbachev deposed, a shooting war somewhere—would traders want to broker or trade and I think most of them would want to trade with monumental news and that leaves you with who is going to fill the order then.

I am talking about customer releases which is one of the things that is in your bill. A dual trading broker would be limited to filling orders only from customers who had signed releases. Some large commercials have indicated to me that they would sign releases. They already use brokers who trade and they know they can trust them. They have confidence in their floor personnel to see that their orders are filled fairly. And since this type of customer generally provides brokers with the most business, the most orders, and gives them the opportunity to trade, there would be where your best, most competent people would be, leaving smaller commercial houses with less competent brokers.

I do not believe that commission houses would sign blanket releases. I do not think their attorneys would let them. They would insist that each customer decide which type of broker he or she wants executing orders. In the view of the publicity in this proposed legislation, it would be my guess and that is all it could be obviously, most public customers would not sign releases. And thus, commission houses would have to find both types of brokers because they had both types of customers.

Referring to Commission discretion, even with the Commission given the discretion in your bill, it still would be a time-consuming affair. That is just the nature of Government and requiring reports to a congressional committee, while I understand it, I believe in it, I do not think there is any doubt it would make the CFTC extremely cautious. And this is in no way a criticism of the CFTC or of the requirement, it is just a fact that such a requirement invites bureaucratic caution, and that could be to the detriment of the market.

I know there has been a lot of talk here today, especially by the Congresswoman from Indiana, worrying about liquidity and trying to determine what is and what is not a liquid market. I do go back 16 years to the soybean market and from personal observation, Mr. Chairman, there were times when between trades there was more than 5 cents and yet there were a lot of activity in those particular markets.

The council does feel strongly about the issue of dual trading because as commercial users of futures markets, our members do not have the luxury of being able to stay out of the markets. They must be able to be buyers and sellers of futures contracts during every minute that the futures markets are open. The economic benefit of additional liquidity is difficult to measure, but it is real and cannot be refuted. Section 101 would force the unknown cost of doing without it onto the commercial users of the market. This would raise costs not only for market users, but for all who produce, use, or consume grain, in short all of us. It seems clear to the council that the cost of this supposed remedy greatly exceeds any perceived benefits.

And also it seems to me, Mr. Chairman, that we have talked about, I think, you have mentioned several times today, the stick and the carrot, there is an old saying that if you really want to get someone or something's attention that a 2 by 4 appropriately applied does the job very well. It is my feeling that the 2 by 4's that have been wielded by Tony Valukas and by this committee have done just exactly that. They have gotten the attention of the exchanges. And I think that was dramatically illustrated by the testimony here today. And it would be my hope that there can be some compromise to allow the audit trails to do the job. I think that in all cases it is better to use medicine rather than surgery. You can always keep surgery as an alternative.

The efficiency of our futures markets must be preserved and enhanced. The council urges you to keep an eye toward what greater contributions American futures markets can provide our country. This very committee continues to grapple with the issues of price risks in the production of U.S. commodities. As production decisions continue to move toward market-driven from Government-driven, the classic risk-shifting functions of futures markets will become increasingly attractive.

I do appreciate the opportunity to be here, and having had some experience with a couple of times when there was liquidation only, if there are any questions, I will do my best.

[The prepared statement of Mr. Lebeck appears at the conclusion of the hearing.]

Mr. ENGLISH. Thank you very much, Mr. Lebeck. I appreciate that. Several exchanges are part of your Council, are they not?

Mr. LEBECK. Yes, sir.

Mr. ENGLISH. So you are very familiar with that aspect of the trade. Of the involvement that you have had, you mentioned the public sector or you were talking about the public individuals, I think, trading, as opposed to grain companies and others that may be looking for various reasons to become involved. What percentage of the trade is made up of those individuals that simply may be cattlemen or a farmer or whatever that may be hedging, say in the Board of Trade? You are familiar with the Board of Trade, I know.

Mr. LEBECK. The last figure I heard on farmer participation, producer participation in the grain markets, and I have to confess, as you know I have not been that active in the last few years, was it ranged probably between 6 and 10 percent. I think that the chances are probably pretty good that that has increased but I would not think it had increased a significant amount.

Mr. ENGLISH. You think it has increased?

Mr. LEBECK. Yes, sir; I do.

Mr. ENGLISH. I was looking at the contracts that we have and particularly the big ones. For instance, now on the Board of Trade, the big contract that is being traded is not wheat or corn or soybeans even, basically the big ones are T bonds.

Mr. LEBECK. My answer was producers, meaning farmers in the agricultural markets.

Mr. ENGLISH. But we are talking about the entire business on an expanse.

Mr. LEBECK. I would have no way of answering that. That would have to come from the Chicago Board of Trade.

Mr. ENGLISH. OK, but coming with these big numbers, 295,000 contracts being traded on an average each day, as opposed to say 13,000 for wheat or 37,000 for corn, or even 44,000 for soybeans. Probably it has shrunk up considerably since the time you were talking about, has it not?

Mr. LEBECK. Are you saying that the agricultural volume is not as great?

Mr. ENGLISH. Or any individuals such as that. Whenever you have these new contracts that have come on the exchange, big contracts, huge trades taking place, high volumes of trades taking place every day. That the percentage of those individuals, if it was back during the time you were talking about, 5 or 10 percent on the agricultural contracts, if we are talking about the entire exchange itself, that has probably shrunk down would it be fair to say less than 2 percent, do you speculate?

Mr. LEBECK. If you back me into a corner, I would agree with you.

Mr. ENGLISH. I was not.

Mr. LEBECK. My figure was the number of farmers who were using the markets as opposed to how much their volume was compared to the total volume.

Mr. ENGLISH. Right. Well, I agree with that. But whenever we talk about the question of dual trading, what we are talking are mature liquid contracts. And say on the Board of Trade, T bonds are definitely mature liquid contracts, would you not agree?

Mr. LEBECK. Yes, I would agree. And I am very very happy that I happened to be president of the exchange when that contract came out.

Mr. ENGLISH. Great, and I am happy too.

Mr. LEBECK. I have just been handed a note which reminds me of something I should know better than the person who handed me the note. NFA transaction fees which apply to nonmembers of exchanges and that does not mean just individuals, but any nonmembers, range in the mid-20 percent.

Mr. ENGLISH. But that would be farms and whatever it may be.

Mr. LEBECK. It could well be pools and firms, not just individuals, yes.

Mr. ENGLISH. That does not give us a very good feel for what we are talking about. The other point that I wanted to go down to, to bring me around to that is basically what we are saying the people who are trading on the exchanges—the majority—are big companies. With regard to grains, we are talking about the big companies. We are talking about Cargill, Bunge and whoever may be wanting for whatever reason hedge or maybe even speculate the markets, correct?

Mr. LEBECK. Yes.

Mr. ENGLISH. OK, given that and you made this statement with regard to a dual trader is really trusted. They trust that broker on the floor?

Mr. LEBECK. Yes, sir.

Mr. ENGLISH. Well that is a different story than what we got from those companies. Those companies tell us, well we do not do that. We do not trust them.

Mr. LEBECK. That surprises me because the ones I have talked to, including one of the firms you named, have told me that they would sign releases for all their brokers.

Mr. ENGLISH. They would indeed. And the reason that they would is because they have their own people on the floor. They have their own people looking over the shoulder of that broker and they have their own surveillance system. In other words, they have their own built-in protection.

Mr. LEBECK. I mentioned that in my statement.

Mr. **English**. But that being the case, it is not the question of whether they trust the broker, what they are doing is they are trusting their surveillance system that they personally have put in place, correct?

Mr. **Lebeck**. For whatever reason, they trust their broker.

Mr. **English**. But whenever we are talking about these individuals, they do not have the surveillance system. They do not have somebody there to look over their shoulder. We had the gentleman here from the Minneapolis Grain Exchange. He was asked the question, could we have 100 percent perfect system. He said, yes, you stick somebody with each one of those brokers looking over his shoulder, yes, we could costwise. And that to a great extent, not totally, but to a great extent is what large companies have done and that is the reason they have built-in the protection themselves. Is that not true?

Mr. **Lebeck**. Yes.

Mr. **English**. And then the other thing, we get down to the question of dual trading. It was said we have the gentleman who was hired by the Board of Trade, Dr. Grossman, and Dr. Grossman's account here stating, there is not that much dual trading taking place. So when we start talking about the markets moving off shore and when we start talking about the impact that this is going to have on markets, the huge impact, and then we come in and find, according to the professor who did the study back in 1986, and he is stating that the frequency of dual trading is itself low. I guess it starts kind of narrowing this thing down and makes you wonder if we may be splitting hairs on a number of these issues.

It appears to me as I mentioned earlier, if what we are really talking about here, taking away a lot of the rhetoric, we are talking about degrees. How much of the standard are we going to have? How much are we going to strengthen that standard? And I know in talking to you that you support a higher standard.

Mr. **Lebeck**. Absolutely.

Mr. **English**. So I just want to say, I think it is important for us to go through and to bring a little bit of this out and should point out that what we are looking for is the overall public. It is the integrity of that system that I think that makes it so successful and makes it so appealing to people not only in this country, but from overseas. We just want to build just a shade more integrity into it.

Mr. **Lebeck**. I do not think anybody I heard today would disagree with that. I would make a couple of comments. Back in my days, I got in trouble periodically by having that attitude, sir. There have been—I know the Board of Trade and I think the Merc—both have had studies on how much of their volume is done by dual traders and the amounts that I recall just offhand run from 20 percent on up. So I realize what is great and small. I do not know what the professor—I do not understand these Ph.D's too well like you, means by great or small, but I think that the volumes do run in those ranges.

Mr. **English**. I think we heard 20 percent being used today.

Mr. **Lebeck**. Did we not hear that today?

Mr. **English**. Yes, the 20 percent was brought up. Maybe the Board of Trade ought to check with the professor in what it means by low. I think that is a good point.

Mr. Lebeck, we are going to look forward to working with you. I know we have already talked about some of these areas and we feel that you all can help us a great deal, and given the experience that you have had. And I know that you are very interested in seeing stronger standards. We are going to be looking forward to working with you.

Mr. LEBECK. As you are, and I thank you.

Mr. ENGLISH. I appreciate your testimony. Thank you very much.

Mr. Jontz, we have a panel up next. I am going to let you lead off by introducing one of our witnesses, if you would, one of your constituents?

Mr. JONTZ. Thank you very much, Mr. Chairman. I am delighted to have the opportunity to do that. Mr. Chairman, I know you have conducted very extensive hearings today and earlier this week, and you have heard from the president of the exchanges, and you have heard from academics, and you have heard from a lot of different perspectives.

I am glad to welcome a constituent from my district who represents a very important perspective to all of us and that is the local country elevator and farmer. I think it is important that we hear from them too. So I am delighted to introduce to you John Fredrickson who is a partner in Kentland Elevator and Supply in Kentland and Newton County in my district. I have represented Newton County in one capacity or another for 15 years, and I know that Mr. Fredrickson brings to us today a very important perspective, and I believe the other witnesses on this panel do also.

I want to conclude my comments, Mr. Chairman, by thanking you again for the tremendous effort you have put into these hearings, and even though I am no longer a member of your subcommittee, I am going to be following your lead very closely and I know that you have done a very thorough and comprehensive job with these hearings. And I thank you very much for allowing me to sit in this afternoon for just a little bit of the testimony.

Mr. ENGLISH. Delighted to have you back and feel free to come by any time. It is always a pleasure to have you with us, and Mr. Fredrickson, the very high recommendation that you got and I want to introduce our other witnesses who have equally high credentials. Mr. Dave Danker who is from Perryville, Missouri. I believe, Mr. Coleman, I am not sure you are from his district are you?

Mr. DANKER. Congressman Emerson's.

Mr. ENGLISH. Congressman Emerson's district, OK. And we have Mr. Joseph Kane, who is floor broker with the Chicago Board of Trade. Mr. Kane, we are happy to have you here today, and Mr. Ralph Weems, who is a former president, American Soybean Association from West Point, Mississippi. Mr. Weems, we are happy to have you, and Mr. Fredrickson, we will let you start off our testimony. And as we have told our other witnesses, if you would care to summarize your testimony, your written testimony will be made a part of the record.

STATEMENT OF JOHN L. FREDRICKSON, PARTNER, KENTLAND ELEVATOR AND SUPPLY, INC.

Mr. FREDRICKSON. Thank you, Chairman English and also thank you Congressman Jontz for the introduction. As Congressman Jontz introduced me, I am a partner in Kentland Elevator and Supply, a country elevator located in Northwest, Indiana. I have been involved in the management of grain elevators for over 20 years, and involved in the ownership of this present facility for the past 11 years. I also own and operate a small farm, serve as an officer of our State grain and feed association, and serve as director of an insurance company.

The firm I represent is an independently owned elevator with three locations. The primary business of our country elevator is purchasing grain from area farmers and reselling it to grain processors, grain exporters, livestock, and poultry feeders.

When we purchase grain from a farmer, we are at risk in the marketplace until we have sold the grain. We may choose to sell the grain through a user for immediate delivery, or we may choose to keep the grain in one of our storage facilities to sell at a later time. If we choose to store the grain, we must transfer the market risk to someone else immediately. This is accomplished by hedging the grain in the futures market at the Chicago Board of Trade. We place an order to sell futures contracts for the amount of grain we have purchased. When we decide it is no longer economically feasible to hold the grain, the futures portion of this transaction is offset by buying futures contracts at the same time the cash grain is sold. Our elevator's margin is the selling basis, less the buying basis.

The execution of the futures orders is a critical component of the transaction. It must be completed at the best possible price and executed very promptly. The liquidity and flexibility provided by dual traders who can trade for their own account as well as execute customer orders, is a contributing factor for our country elevator to provide the best price at the lowest cost.

Sometimes we may determine that it is not economic to sell the cash grain as the futures expiration approaches and decide to roll the hedge forward to a deferred contract month. This transaction is called a spread, since it involves the simultaneous purchase and sale of futures contracts in different months. Successful execution of a spread trade is obtained by utilizing an experienced dual trader who can leg into the position by executing one side of the trade when futures prices for that contract are more favorable. He may not be able to obtain the desired price from the other leg of the spread, but may place it in his own account at possibly a slight loss in order to satisfy the customer and keep his business. The ability of the dual trader to obtain favorable prices for spread trades helps increase the liquidity in relatively less deferred contract months, and results in more accurate indications to market participants of the cost of carrying commodities.

The banning of dual trading could increase transaction costs for our elevator by widening bids and offers due to less pit participation. This increased cost will cause either a reduction in our return on investment, or most importantly a reduction in prices paid to farmers by our firm.

Dual trading increases the supply of both brokers and floor traders because a dual trader can earn income from two sources to cover cost of training, an exchange seat, and time spent on the floor. Dual trading encourages greater competition between brokers, thus keeping commission costs down. If dual trading is banned, the best brokers will trade for their own account, decreasing the number of brokers available to execute orders for our elevator. This will reduce the liquidity of the marketplace, thus making it more difficult to have our orders executed promptly at the market.

Dual trading is voluntary on the part of customers; customers can now prohibit their brokers from dual trading if they choose. Additionally, U.S. futures exchanges are engaged in a continuing process of improving their market surveillance systems. If abuses can be curbed through adequate surveillance, there is no reason to eliminate the practice like dual trading which contributes to the liquidity for which American markets are known.

Simply stated the ideal legislation would preserve dual trading while ensuring the exchanges bear the responsibilities for detecting its possible abuse. I strongly urge Congress to evaluate the pros and cons of dual trading before making a final decision on this vital issue. Your decision will effect the entire agricultural industry, as well as the future of our markets.

[The prepared statement of Mr. Fredrickson appears at the conclusion of the hearing.]

Mr. **English**. Thank you, Mr. Fredrickson. Mr. Danker.

STATEMENT OF DAVE DANKER, VICE PRESIDENT AND GENERAL MANAGER, BUCHHEIT GRAIN, INC.

Mr. **Danker**. Chairman English and members of the committee, my name is Dave Danker, and I am the vice president and general manager of Buchheit Grain, Inc., located in Perryville, Missouri. Buchheit Grain is a small, family owned feed, grain, and general merchandise business founded in 1934.

My purpose in coming here to speak to you today is to attempt to explain how we use the futures markets, in particularly the spread market to effectively manage our business, and how that relates to one of the subjects your committee is reviewing, that is, dual trading. We have approximately 1,250,000 bushels of space in two different locations. In order to survive as a grain merchant, we must fill all of our space at harvest and hopefully handle 60 to 70 percent of that volume once again after harvest.

In order to manage this need in a business-like manner, it is imperative that we prespread our space and the volume of grain that we hope to handle post-harvest. A brief example of prespreading would be a simultaneous purchasing of 10,000 bushels of December corn futures while selling 10,000 of March corn futures. As the corn is purchased from farmers during October, we would simply sell the December corn futures. This would automatically spread the purchase out to the March futures position.

Prespreading is an inexact science, but as one gains experience, it becomes easier to establish reasonable goals and achieve them. We like to enter our spread orders prior to the time the contract actually trades. Oftentimes this results in getting a good fill that may never be available at any other time during the marketing cycle. Quite often, due to poor liquidity in those distant contract months, our broker has to leg a spread in order to have it filled. By legging the spread, the broker first takes one side of the spread, then fills the other side as soon as he is able.

During the time elapsed between the execution of both legs of the spread, the broker assumes the risk of not getting the spread filled at or above my order. If he fails to accomplish that fill and ends up trading the spread at a lesser amount, the loss is for his account. The broker's ability to dual trade gives him an opportunity to offset these losses by trading for his own account throughout the day. I feel that this will make spread brokers more willing to take chances in order to get their customers the best possible fill, thereby maintaining their reputation and position in the marketplace.

I had a personal experience with this situation last winter that I would like to share with you. Last January, I began planting for the 1989-1990 marketing year. I budgeted the purchase of 200,000 bushels of soybeans at harvest. And I estimated that we could buy at harvest, store, and later resell soybean, if we could get our November/March spreads set at 17 cents per bushel or better. I called my trading firm and entered a broker to spread 200 November/March soybeans at 17 cents or better. A few days after the March contract first came on the board, my spread got filled at 19 cents. Given what I know about spread conditions at that time, I have to assume that the trade was legged.

And I realize that not all trades have such a happy ending, but I believe it illustrates my point that if you trade through a brokerage firm that does the job in policing and controlling the trading activities of the brokers that it uses, you can get good honest fills. It seems to me that if one is knowledgeable about the current conditions of the market, offers spreads, options and some futures transactions at a given level or better, he will obtain the fill he wants.

The key to obtaining these fills is in prior evaluation of the quality of broker that you choose to deal with and in the existence of surveillance systems that detect and deter abuse. The issue is not whether the broker dual trades. The real issue is whether or not there are adequate monitoring systems in place to detect cases where the practice of dual trading is abused.

In summary, I would like to stress that I feel the current system of allowing brokers to both fill orders and take risks for their own account, provides a more liquid market, and most probably a more aggressive trader. The system, as it exists, has provided us with the structure to build a successful small business. I would like to encourage you to provide a means for protecting and improving the integrity of the current system of dual trading rather than changing something that, in my mind, already works. Thank you.

[The prepared statement of Mr. Danker appears at the conclusion of the hearing.]

Mr. ENGLISH. Thank you, Mr. Danker. Mr. Weems.

STATEMENT OF RALPH WEEMS, FARMER, FORMER PRESIDENT, AMERICAN SOYBEAN ASSOCIATION

Mr. WEEMS. Thank you, Mr. Chairman and Mr. Coleman and members of this subcommittee. I am a farmer from West Point, Mississippi. I believe I am the only farmer we have had here today. But I have been involved with soybeans for 30 years. I have been associated with the Mississippi Soybean Association for 22 of those years, and I worked my way up to the presidency of the American Soybean Association in 1984. I should briefly depart from this and say that the views that I am expressing today are mine and not necessarily those of ASA.

I became associated with the CBOT through the agricultural advisory committee in 1984. I was elected chairman of that ag advisory committee in 1985 and the chairmanship of that committee carried with it a 3-year term on the board of directors as a public director, a seat that I held until February 1988.

While I was at the Chicago Board of Trade as an outside director, several cases came before the board at that time, one which I vividly remember and would like to call to your attention at this time. It had to do with a trader who was suspected of outside—not outside trading—but front running and this was naturally very interesting to me as a farmer to see how a fellow director would approach this thing with me as an outsider on their group. But, sir, it was my opinion and I hold that opinion to this day, that those gentlemen took that hearing to the deepest part of their heart and that they did their dead level best to do what was supposed to be done at that particular time.

The board's decision on that case was explosion. I said then and I repeat now, that I wish every farmer in America could have been there that day and seen what happened. Because I think it would increase the confidence in our market system enormously. I have, as I stated, had tremendous confidence in the board and I still have that confidence today. Thank you, sir.

Mr. ENGLISH. Thank you Mr. Weems. Mr. Kane.

STATEMENT OF JOSEPH J. KANE, FLOOR BROKER, CHICAGO BOARD OF TRADE

Mr. KANE. Chairman English, Mr. Coleman, and Mr. Jontz, first I would like to thank you very much. Ralph said he thinks he was the only farmer here. I know I am the only floor broker trader here. My name is Joseph Kane. I am a member of the Chicago Trade since 1952. I have also been a member of numerous other exchanges, including Chicago Mercantile Exchange and the New York Coffee and Sugar Exchange. For 7 years, I was the director of the Chicago Board of Trade and served on most of the major committees of the exchange, including the business conduct and the floor governor's committee. In fact, in 1968, I was the chairman of the reorganization committee of the exchange that was responsible for introducing public members to our board of directors, also out of town directors to our board of directors, and creating the floor governor's committee which has the primary responsibility for policing the conduct of our members on the exchange floor.

I was born, raised, and educated in Chicago and I am the father of eight children. Many of my children have worked in one capacity or another in the futures business. I have been at the Board of Trade so long that I can say that I knew the grandfathers of two of our present directors. I say this for a reason and I hope it will become apparent.

I know the Board of Trade's rules, customs, and practices. I have seen those rules, customs, and practices evolve. I have also seen the competition for business which exists on the floor and the solid ethical standards which are upheld by most members combined as a potent force for the protection of the customer.

Nevertheless, I know that this subcommittee is concerned about the practice of dual trading. I believe I am in a good position to discuss this practice and the results which govern this practice because throughout my 37 years as a floor broker, I have also routinely traded for my own account. Over the years, I have given a lot of thought to dual trading. In 1975, I was coauthor of a study on that topic which formed part of the report of the chairman of the advisory committee on the regulation of contract markets and self-regulatory associations of which I was a member. As you remember, when the CFTC was formed, there were four groups formed to aid from the industry. I was privileged to be a member of one of those groups.

In that report, we came to the conclusion that dual trading was a major ingredient in the liquidity of our markets and that its elimination would impair that liquidity without conferring any measurable benefits on the public. We recommended that dual trading be preserved, but that rules be adopted which clearly prohibit a broker from buying or selling for his own account while holding orders for others at the market price at the same time. We also recommended that surveillance systems be improved, so that the exchanges in conjunction with the CFTC could ensure that abuses of that and other practices were detected and punished.

I believe our recommendations were valid then and that the last 14 years have vividly demonstrated their validity. In the intervening years, our markets have enjoyed unprecedented growth in volume and liquidity, making them the envy of the world. At the same time, the Chicago Board of Trade and other exchanges have adopted straightforward rules to make the misuse of dual trading, that is, trading ahead of the customer order, a trade practice violation.

And most important of all, over the last 10 years, and in particular the last 5 years, the exchanges have taken strides unimaginable in 1975 to create and implement effective surveillance systems for detecting all trading abuses, including trading ahead. In particular, the computerized audit trail codesigned by the Chicago Board of Trade and the Chicago Mercantile Exchange has demonstrated a detection and deterrence capability offered by no other financial markets in the world. At least that was the view expressed by Nicholas Brady as head of the Presidential task force which studied the 1987 stock market crash which was alluded to by Mr. Melamed this morning in his testimony.

I do not pretend to speak for the entire floor broker community, but I know if I conducted a survey of the many many responsible floor brokers whom I work with each day or whom I know around the various exchanges in the country, they would want to stress for you the following points. First, they would like to tell you that you would take away a major means of servicing their customers if you take away the dual trading privilege from the broker, as in the manner that it was just outlined to you. Dual trading allows the floor broker to go after the best fill for his customer, knowing the broker has the flexibility, if necessary, to trade out of resultant losing positions through his personal account whenever the opportunity arises.

Second, they would tell you they support the adoption of the best, most comprehensive surveillance system devisable as a means of protecting themselves as well as their customers. That is an important point that a good surveillance system protects the broker, as well as the customer.

The message I would leave with you is simple. We have the best most liquid markets in the world. I am not an economist, but I believe the rational review of the economic literature available on the subject will lead to the conclusion that dual trading has contributed to the unrivaled success of our markets. In copying every aspect of our market formula in an effort to win business from us, foreign markets have also copied us in permitting dual trading. The foreign markets do not have our surveillance capability. They do not have the know-how and they do not have the commitment to eliminate trading abuses and the perception that abuses exist. Let us use our know-how and our commitment to keep U.S. markets in their preeminent position. With your help, we can preserve our liquidity, and all of the factors that contribute to it, including dual trading, while reinforcing the integrity for which we must be equally well known.

As a little adjunct, I would like to say that I think that I have showed you that for more than 20 years, our goals have been the same. I do not speak for anyone but myself, but like the exchanges, my goal has been to try to be of help in this instance, and I hope that I have been of some help today.

[The prepared statement of Mr. Kane appears at the conclusion of the hearing.]

Mr. ENGLISH. Thank you very much. I appreciate that, Mr. Kane. One thing that I guess puzzles me a little bit, Mr. Kane, is this particular legislation we are looking at has a provision in it that says, anyone—any of these three gentlemen—who does not care whether their broker is involved in dual trading or not, all they have to do is sign a paper saying, I recognize my broker is involved in dual trading. It is fine with me, give him my blessing. Approve him. That is it.

We have had testimony today—I mentioned Dr. Grossman, but we will go back to the earlier testimony—that some 20 percent of the trades may have dual trading involved. So we are talking about any contract, any particular contract that we are talking about, and let us assume that we go with the 20 percent. Then we fit into the question that any customer who so wishes or does not care whether his broker is involved in dual trading signs off for it.

We have also heard that the majority of the business on any contract is going to be firms, grain companies, and so on and so forth, and they have their own people looking over their shoulder. I guess after you fit all of that together, it is hard for me to understand, how this is going to have that kind of major impact on any contract, I do not care what it is. Because if in fact you gentlemen are representative and you do not care or you support dual trading, everybody signs off. Though there is no impact, is there? Is that not true, Mr. Kane?

Mr. KANE. I think that you have one segment of an industry here that would sign off perhaps on this situation, but I think Mr. Lebeck brought up an important point in his earlier testimony. Although the commodity head of a particular futures commission merchant may be perfectly willing to sign off or to solicit his customers' opinions, I am not sure that their legal department—and I am not an attorney—would allow that to happen.

Mr. ENGLISH. Let me point out though, the model that we are following comes from the Chicago Mercantile Exchange. That is where it comes from. That is where that provision comes from. Their lawyer does not seem to have a problem with it. He does not seem to have any difficulty with it. The thing that I wonder about, we were talking earlier about with Mr. Lebeck, the Chicago Board of Trade today may have less than 2 percent—I am probably being too generous, maybe even less than 1 percent, maybe even less than one-half of 1 percent—of their trade represented by gentlemen like we have here, whether it be farmers or whatever, a very very small percentage.

We have then the contracts, the trading that is taking place on these contracts are by firms, big firms. If they do not have any problem with dual trading, fine with me. They sign off. They have their own people there. They run their own business. So I do not understand where all these people are going to be driven away from this market because we have the provision that says that folks that do not want their particular broker involved in dual trading have a right to say so, and—our right to refuse to give that approval.

How much business are we going to lose because of that, Mr. Kane? How much business would you lose? How many of your customers that you have, do you feel would not sign that paper for you?

Mr. KANE. I do not have any idea how many would or would not sign because I have a business that is both commercial and retail business. And the retail business would be in jeopardy because of what I brought up before. And I think that would be the important aspect personally that I would look at in that regard. It would force me to make a decision.

Mr. ENGLISH. What kind of decision are you going to have to make?

Mr. KANE. I would have to make a decision whether or not I would remain a broker or whether I would become a trader.

Mr. ENGLISH. Why?

Mr. KANE. Because if 50 percent or more of my income were to be displaced——

Mr. English. If you have all of these customers out there and it seems to me, everything I have heard of you, Mr. Kane, you are a very reputable person, one who has an excellent reputation. I am sure that over the years you have built up an awful lot of satisfied customers. Do you think that just simply because, hey, folks, customers, I am involved in dual trading. Most of them already know it, do they not?

Mr. Kane. Yes.

Mr. English. And if they know that, how many of them do you think——

Mr. Kane. I jumped to a conclusion. May I define a customer in my mind?

Mr. English. Sure.

Mr. Kane. A customer in my mind has a twofold aspect. A customer in my mind may be a futures commission merchant and then the ultimate customer would be the customer of the futures commission merchant. The relative retail customer of that futures commission merchant would not know necessarily who this order is going to. He would judge it on the basis of the futures commission merchant. That is where the difference——

Mr. English. It is his money. Should he not have the right to make that decision?

Mr. Kane. Oh, yes. He has that right—right now.

Mr. English. How does he have that right? He can tell that commission merchant, I do not want anybody that is involved in the dual trading carrying out my order, and how does he find out for sure that that is done?

Mr. Kane. I do not know how he finds out.

Mr. English. That is the problem we are into. The thing that comes down. As I said, here we are talking about 20 percent of the business. And then we are talking about narrowing that on down—the lack of confidence that I sense in the industry about getting customers to sign that paper is frankly surprising. I felt that most brokers, most people in industry would be very confident that the customers are satisfied, the customers are happy. You gentlemen here seem very satisfied with the arrangements that you have with whoever your brokers are. You seem to me to be the kind of gentlemen that would sign that paper. Would not you three? Any one of you who would not sign it?

Mr. Danker. Yes, I would, sir, and I think our degree of satisfaction has come over years of education and experience with a particular broker, and our confidence is built up probably more so in the futures commission merchant.

Mr. English. So you do not know who your broker is, do you?

Mr. Danker. I do not know, but we have the ability to watch our trades as they are entered and see how they are filled.

Mr. English. How do you do that?

Mr. Danker. We have up to the second quotations on our screen.

Mr. English. But you do not know whether this guy that is out there—you do not know who this broker is? You do not know what he is doing?

Mr. Danker. No.

Mr. English. So if he in fact traded ahead of you and he was not picked up on the audit trail, you would never know it would you?

Mr. DANKER. No, sir. But I would know what kind of fill I got, where the market was at when I placed the order.

Mr. ENGLISH. But you do not know whether you were cheated or not?

Mr. DANKER. A fraction of a cent, probably not, sir.

Mr. ENGLISH. The question I am coming down to, to you it does not matter? You are willing to sign off?

Mr. DANKER. Yes.

Mr. ENGLISH. Do you think the overwhelming majority of the people that are in your business would feel the same way?

Mr. DANKER. Yes, I believe so.

Mr. ENGLISH. OK, what is the fear? If you end up with 75 percent of the people in the business that are willing to sign that slip, and we end up now that is 20 percent of the business that is involved in dual trading all together, so you have 75 percent of 20 percent. And the other individuals, that does not mean that they are leaving the market, they are simply saying, hey, I want a guy out there who is not involved in dual trading. I mean they are going to be in there trading. Their business is not going away. Now where is the threat? Can you tell me that, Mr. Danker?

Mr. DANKER. I do not know, sir. I am not in a position to talk about the technicalities of the futures market. I only know the experience from my end.

Mr. ENGLISH. But would this satisfy your concerns then? You are able to have your trader—he is able to continue to do business just like he is today. Does that not take care of your problem?

Mr. DANKER. Yes, sir. I think you would see an instance maybe where the people that did not sign off would though would get—the better traders are going to choose to trade for their own account.

Mr. ENGLISH. Well, that is fine, but that is their choice, right?

Mr. DANKER. Yes.

Mr. ENGLISH. They may see it another way. They may decide, hey, I am concerned. I do not know who this guy is that is a broker for me. I do not want some guy that is dealing for himself. That is their decision, right?

Mr. DANKER. Yes.

Mr. ENGLISH. Mr. Fredrickson, does that take care of your problem?

Mr. FREDRICKSON. Yes. Of course, any time we take away brokers or whoever it might be in the marketplace, we do reduce competition.

Mr. ENGLISH. How do we take away a broker?

Mr. FREDRICKSON. In other words, we eliminate the people that will be dual trading.

Mr. ENGLISH. I do not understand how we would do that. If we had Mr. Kane here. Mr. Kane has been in the business for some time. He has a lot of customers. Mr. Danker has people that he has faith in. They are not going to desert these people. You have said yourself you are going to sign off. In the case of Mr. Danker, he has brokers doing his business that he does not even know. But he has confidence in the firm that he uses to have the right people. That is fine; that is great. He signs off on that.

They are certainly going to be able to continue to do dual trading. What we are going to have evidently, if you gentlemen are any kind of representatives, is a very small percentage out here that said, until we get a better system, until we can feel confident that we are going to be able to deal with this problem, I just as soon have somebody who is not involved in dual trading. And there is going to be somebody to pick up that business. That is the American way, is it not? Where there is a need, there is going to be somebody out there. So why deny them their chance.

I guess what I am coming down to is it seems to me that we have taken care of your need. We are not running Mr. Kane out of business. Mr. Kane can continue to do dual trade. He may have some people who do not want him to dual trade. Maybe he has people stacked up because of his good reputation that just love to—you do not have any of those, you take all comers, do you, Mr. Kane?

Mr. **KANE**. No, I do not take all comers, but I will be glad to take any business that you might have.

Mr. **ENGLISH**. OK, but see my point is that the legislation does not ban dual trading, that is the whole point. It takes care of those people who are happy with their brokers and do not care if he is involved in dual trading, and give them their opportunity to do so. It takes care of those people who do, who are concerned about it. It gives them a chance.

It probably is going to develop a new market. You are going to have some folks out there, say, hey, I think I can go out there and pick up these people who are concerned, and I will make more money doing that than I am being involved in dual trading. We have an awful lot of traders out there that are not involved in dual trading; is that not right, Mr. Kane? They are simply traders.

Mr. **KANE**. They are simply traders, certainly.

Mr. **ENGLISH**. So they may pick up a little business. We are not losing anybody on this thing. And as far as the liquidity in the market, we are going to find there is very little chance because that customer still has the need, no matter whether you are using a broker or trader. He still has the need and he is still going to be involved.

So the thing we have come down to is, I recognize that folks do not like to change. You know, if you have a good deal and it is working fine, well that is great. What we are saying, and I think the exchanges agree with me, is that we are pushing. We want to see a little higher standard. We want to see them do a little better. We have a little more faith in them. We think they can do better. And as I said, we are using a little bit of a carrot and stick.

Mr. Weems, I did not ask you, does that pretty much take care of your needs too?

Mr. **WEEMS**. Yes, sir. It would take care of most of the farmers' needs. I see nothing wrong with it. It may take away a little of Mr. Kane's business, but maybe he will get some more.

Mr. **ENGLISH**. He may do better. The thing that we are coming down to, that is what we are going to try to address, and we do not want to do anything that is going to be harmful to the market. We built an awful lot of safeguards in this system. Mr. Kane.

Mr. **KANE**. Mr. Chairman, may I address two things that I think are important in this area?

Mr. **ENGLISH**. Sure.

Mr. KANE. One, it probably would have an impact on the young men or young women who are starting in the business from the standpoint of being brokers. It would probably have impact on those people. I do not want to expound on it. It is 6 o'clock and that—but if anybody on the staff would like to talk about it, I think that would be important. Let us leave it at that one.

Mr. ENGLISH. We would like to visit with you and take that into account. We sure would.

Mr. KANE. I think there are a few impediments.

Mr. ENGLISH. Mr. Coleman, do you have any questions? Mr. Jontz.

Mr. JONTZ. Mr. Chairman, let me say thanks to each of the witnesses for their statement. And I wonder, Mr. Chairman, if it would be out of line if I took advantage of the opportunity to ask Mr. Fredrickson for his observations and his perspective of country elevator about the recent soybeans futures controversy with the Chicago Board?

Mr. ENGLISH. That subject has come up today, so feel free.

Mr. JONTZ. Mr. Fredrickson, what is this going to mean for farm income and what effect is this going to have in the long term on bean prices, and what perspective do you think the Congress ought to take with regard to this matter?

Mr. FREDRICKSON. Well, I might say that as we have all heard today, the Chicago Board of Trade did take action. They are being highly criticized by some people in the marketplace and in the public for the action they did take. However, if they had not taken action and the consequences had developed, they would have been severely criticized for not making the move that they did. Quite frankly, I do not feel that this has had a severe impact on the price of soybeans over the long pull. Temporarily, yes. On the days that there was a large liquidation of these contracts, the July contract, for example, today beans were down severely.

However, when we get into this situation the exchange or the speculator is always the culprit. However, I think about 1 year ago when we had the drought situation, and soybeans futures reached $10 a bushel, I did not hear any criticism of the exchange or the speculate. I, as a hedger, had problems meeting my margin calls those days because of the grain that I had hedged.

Mr. JONTZ. Do any other members of this panel want to tackle that question while you are here?

Mr. WEEMS. Mr. Jontz, I do not want you to take this too lightly, but I think the general rain that they had in the Midwest over the last week probably had more to impact the price of futures soybeans than the action that the Chicago Board of Trade took. And I come from a place where we are up to here in rain right now.

Mr. JONTZ. Let me thank you again for your testimony to the committee.

Mr. ENGLISH. Thank you very much, Mr. Jontz. I appreciate that, and I want to thank you gentlemen. And as I said, if you got any other ideas, suggestions or whatever—Mr. Kane, I am glad that you came down. I will tell you it is a great help to us, and I know that you have a lot of your colleagues back in Chicago that are apprehensive with regard to this legislation, but just tell them that we are working with the exchanges, with CFTC, with everyone else, and we want to try to get this to the point that what we are searching for is that we are going to establish a standard. It is going to be a little higher than we are right now, but we want to make sure it is reachable, obtainable, and we will encourage everybody to move in that direction, and we want to make this whole system workable.

Mr. KANE. Mr. Chairman, as I told you, I feel that we have common goals. And I thank you for the opportunity to be here today. It has been very short notice on my part. I had not prepared as much as I would like, and I know the time constraints involved, but I thank you for the opportunity. We have the very same goals. I think the surveillance system will be improved because it is immeasurably improved, as some of the people from the CFTC who have been there from the beginning will tell you, and some of your own staff perhaps. And it amazes me because I have not been involved intimately with these things over the years.

But I thank you very much for the opportunity, and I would like to take this opportunity to thank a Mr. O'Conner whom I have never met until today from your staff. I call him on occasions to find out some information about what is going on and he is most helpful. I met him for the first time today.

Mr. ENGLISH. Do not say too much, he will be wanting a raise next. Be careful with that phrase.

Mr. KANE. Well, he would not be unique in that spot.

Mr. ENGLISH. That is true. I want to thank you very much, Mr. Kane, and if you get any other ideas or any of your colleagues in Chicago get any ideas, we would be happy to hear them. Thank you very much.

We will recess, subject to the call of the Chair.

[Whereupon, at 6:20 p.m., the subcommittee adjourned, subject to the call of the Chair.]

[Material submitted for inclusion in the record follows:]

NATIONAL CATTLEMEN'S ASSOCIATION
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Testimony on Behalf of the

NATIONAL CATTLEMEN'S ASSOCIATION

regarding

H.R. 2869
The Commodity Futures Improvement Act of 1989

before the

House Committee on Agriculture
Subcommittee on Conservation, the Credit and Rural Development

submitted by

Robert D. Josserand, President

July 20, 1989

- -

The National Cattlemen's Association is the national spokesman for all segments of the beef cattle industry--including cattle breeders, producers and feeders. The NCA represents approximately 240,000 cattlemen. Membership includes individual members as well as 47 affiliated state cattle associations and 26 national breed associations.

Good morning. Mr. Chairman and members of this Subcommittee, my name is Robert D. Josserand, I am from Hereford, Texas and currently serve as President of the National Cattlemen's Association (NCA). I own and operate commercial feedyards in Texas and Arizona. We thank you for the opportunity to express our views. The NCA has representation on the Commodity Futures Trading Commission (CFTC), agricultural advisory committee, a futures subcommittee chaired by Jack Frick of Scott City, Kansas, and in 1987-88, a task force charged with making recommendations to improve the contract specifications. Today, the NCA and the Chicago Mercantile Exchange (CME) continue working to achieve significant improvements in the cattle futures contracts.

There is always room for improvement as indicated by the FBI investigation publicized earlier this year and recent actions in the Board of Trade soybean pit.

We at NCA commend you for moving forward in a timely manner with hearings and the subsequent introduction of H.R. 2869, The Commodity Futures Improvement Act of 1989. NCA has a strong history of activity on CFTC reauthorization and related futures issues. The integrity of the markets is an absolute necessity if cattlemen are to use these risk management tools effectively.

Our comments today will address the bill titles as introduced:

Title I - LIMITATIONS on CERTAIN TRADING PRACTICES

Dual Trading--NCA supports elimination of dual trading. Currently, brokerage house orders are time-stamped going into and out of exchanges, but pit broker cards submitted for clearing are only indicated by 30 minute time-brackets. A one minute audit trail cannot be reconstructed with the 30 minute bracketing of pit broker cards. Elimination of dual trading is recommended across all commodities or those pits eliminating dual trading will be placed at a competitive disadvantage. Traders or associations wishing to continue dual trading will migrate to pits where it is allowed unless the practice is universally banned.

NCA is sympathetic to claims that elimination of dual trading could reduce volume traded in some contract months. At this time, however, it is believed that the loss of public confidence from allowing dual trading outweighs the potential gains from the additional liquidity provided by continuation of the practice. Producer confidence is paramount to their continued use of the markets.

Trading among Members of Broker Associations--Public confidence in futures markets could be increased by disclosure of broker association membership. NCA supports membership disclosure and elimination of dual trading for individual traders and banning members of a broker association from trading for their personal accounts in all Exchange markets against orders executed by members of the same broker association regardless of profit sharing arrangements. Allowing dual trading to continue within broker groups but prohibiting it by individual traders places the individual trader at a comparative disadvantage while doing little to address the intuitive concerns associated with dual trading.

Title II - ENHANCEMENT of REGULATORY and ENFORCEMENT ACTIVITIES

Audit Trails--As long as pit broker cards are bracketed into 30 minute segments, narrowing the audit trail for outside paper will be relatively meaningless. Increased audit procedures to cross-match information on a pit broker's card with the brokerage house's outside orders is supported by NCA. NCA also recommends increased research into the use of hand-held electronic recording devises or other emerging technologies to record pit broker transactions in lieu of the traditional hand recorded pit broker cards.

NCA supports the concept of separate time brackets for market openings and closings. Opening and closing of trading sessions often have a wide trading range. NCA recommends increased auditing to evaluate if fills for pit brokers are better than for outside orders. Statistical probabilities of equal treatment among pit brokers and outside traders are recommended for orders filled on the open and close.

Closer and more frequent monitoring of positions held by registered "commercial" traders is recommended to assure that those positions are in fact bonafide hedge positions. Auditing procedures may be required to establish that the commercial trader in fact has product or orders in the physical market that are being offset by hedge positions in the futures market.

Undercover Operations and Enforcement--NCA communicated directly with CFTC chairman, Wendy Gramm, and urged complete and full cooperation as soon as the ongoing FBI investigation was publicly announced. Continued cooperation and participation by CFTC with other investigating agencies will increase public confidence in the integrity of futures markets.

In response to NCA activities, USDA and CFTC agreed on formal liaison activities in October 1987. Full cooperation by the CFTC with other regulatory and enforcement agencies will enhance the overall effectiveness of the regulatory effort.

Self Regulatory Organization Disciplinary Committees and Governing Boards--NCA supports the concept of self-regulation by the futures industry with continued strong oversight by the CFTC. Strict adherence to the increased penalties proposed by the CME Special Committee to Review Trading Practices and other regulatory measures will be more meaningful than increasing the number of CFTC personnel on the trading floor. The concept of CFTC as a strong oversight regulator with adequate resources to monitor trading practices is a more viable concept than increased physical presence in the trading pits.

Strengthening self disciplinary committees will help restore integrity to the markets. Greater representation by non-floor membership is a necessary step. The CME currently appoints one non-voting member and two members each to the Live Cattle and Feeder Cattle Committees. NCA has had past representation on the CME Board of Governors. We encourage and support continued and increased representation on exchange governing boards and disciplinary committees.

Required Registration of Floor Traders--Any action to ensure that individuals operating as floor traders or brokers are legitimate will increase market confidence. As we have seen recently, a few bad apples can leave the public with the impression the whole bunch is rotten.

Enhancement of Registration Requirements--NCA supports increased admission requirements. More comprehensive background checks coupled with a required formalized education program should be mandatory.

Enforcement of Civil Money Penalties--The concept of self regulation with strong CFTC oversight is supported by NCA. Without strict enforcement of penalties, regulation lacks the teeth to ensure compliance with self-imposed rules.

NCA supports the adoption of trading guidelines for rule violations as recommended by the CME Special Committee as follows:

A. Major rule violations
   1. First offense - Six months suspension of all membership privileges; and
   2. Second offense - Expulsion.

B. Minor rule violations
   1. First offense - Thirty days suspension of all membership privileges;
   2. Second offense - Six months suspension of all membership privileges;
   3. Third offense - One year suspension of all membership privileges; and
   4. Fourth offense - Expulsion.

NCA supports banning members committing any major rule violation or more than one minor rule violation within the last five years from serving on exchange disciplinary or oversight panels.

Ethics Training for Registrants--The integrity of self-regulation is directly tied to ethical standards. Extensive ethics training will establish both the seriousness and recollection of ethical standards.

Title III - no specific comments

Title IV - no specific comments

We have a few other comments we would like to share with the Committee. Permanent authorization of the CFTC is supported by the National Cattlemen's Association. This permanency is long overdue and will allow the Commission to redirect some of its funds to accomplish the expanded tasks as outlined in H.R. 2869.

Adequate numbers of highly trained, qualified, experienced personnel are central to the accomplishment of any mission. NCA supports CFTC requests for increased personnel and funding, which have been outstripped by growth in the futures industry during recent years. On one specific issue, periodic verification of positions held by commercial traders as bonafide hedges is the type of information that increased surveillance should create.

The use of electronic systems in place of "open outcry" offers unlimited advantages in recordkeeping market surveillance, ease of use, and opens opportunities for additional refinement of Computerized Trade Reconstruction. NCA strongly encourages the exchanges to implement electronic trading systems during normal trading hours as an alternative to "open outcry" as these technologies become refined and perfected.

The reauthorization is a lengthy process and we appreciate this Subcommittee's efforts. Our members share many of the same concerns you have heard from other market participants. Returning market integrity, in light of the recent investigation, and establishing CFTC as the futures regulatory agency are sought by everyone.

Mr. Chairman, NCA is willing to assist you as this process moves forward. I will eagerly entertain questions.

TESTIMONY

OF

LEO MELAMED

CHAIRMAN OF THE EXECUTIVE COMMITTEE
AND SPECIAL COUNSEL TO THE BOARD

CHICAGO MERCANTILE EXCHANGE

BEFORE THE

U.S. HOUSE OF REPRESENTATIVES

COMMITTEE ON AGRICULTURE, NUTRITION AND FORESTRY

SUBCOMMITTEE ON CONSERVATION, CREDIT AND RURAL DEVELOPMENT

JULY 20, 1989

* * *

Mr. Chairman, members of the Subcommittee, my name is Leo Melamed. I am Chairman of the Executive Committee and Special Counsel to the Board of Governors of the Chicago Mercantile Exchange (CME). Accompanying me is William J. Brodsky, our President and Chief Executive Officer. We welcome this opportunity to appear before you today and to offer our comments on the Commodity Futures Improvement Act of 1989 (the "Bill").

We have devoted substantial attention to the proposed Bill and have prepared a detailed analysis, which is appended to our testimony. That Bill clearly demonstrates that this Committee has worked diligently and very quickly to understand the major issues confronting the futures industry. In many respects, the sponsors have proposed legislative resolutions of those issues which are substantially similar to the rules that have been adopted or are in the process of being adopted by the industry.

Even where the industry approach to the issues differs from the solution that would be imposed by the Bill, the CME and the Bill's sponsors share the same basic goals: We both want to insure the integrity of our markets and bolster public confidence in that integrity. However, the CME and the other exchanges are beholden to yet another principle; those basic goals must be pursued in light of the need to maintain efficient and competitive markets.

The U.S. futures industry is not immune from the challenge of either domestic or foreign competition. If U.S. futures markets cease to efficiently perform their risk transference function, both domestic over-the-counter markets and off-shore futures markets will immediately fill the void. Neither of those competitors is subject to comparable regulation.

The challenge now is to resolve any concerns about the industry's ability to detect and prosecute customer abuse without, in the process, impairing the industry. The media reports of undercover investigations in Chicago and New York impose tremendous pressures on all of us to take some dramatic action. We know that the industry is prepared to act and that our response will be both timely and effective.

We differ with the approach of the proposed Bill, however, in that we do not find the need for Congress to modify its well-proved policy of requiring effective self-regulation subject to oversight by the Commodity Futures Trading Commission (CFTC). Moreover, a policy that shifts to dependency on the legislative process is unlikely to be effective when it attempts to address the details of every issue.

The Bill's sponsors obviously considered this problem and chose to deal with it by giving the CFTC power to overturn the provisions of the Bill if in practice they prove destructive. This "escape clause" approach will have difficulty in application. First, that remedy does not operate until after the damage has occurred: the industry may never recover. A market lost will not be regained. Second, it is not practical to expect prompt curative action from a federal agency subject both to the usual bureaucratic constraints and by a requirement that it certify to Congress that no harm will ever occur because of its negation of a legislated prohibition. Inaction is the more likely result.

The current situation is reminiscent of an incident that occurred during the early days of the audit trail debate. One prominent regulator came to observe the trading pits so that he could suggest improvements to our audit trail. He watched for several hours, and agreed that the propensity for heavy order flow during periods of highest volatility made it impossible for the broker to accurately time record every trade while he executed the orders in a manner which served the best interests of his customer. The regulator had a categorical solution. "**Slow down the trading**," he ordered.

He was correct. If we had imposed a limit on the speed at which we allowed prices to move and the number of executions that could be done each period, we could have achieved a perfect audit trail and eliminated the possibility of most trading abuses. Of course, in such a case perfection would be achieved at the cost of destruction of the market and its universally acknowledged benefits. That kind of perfection is symbolic of the markets in Russia.

The U.S. futures industry has had an outstanding record of growth, innovation and service to its customers. That history was made possible because the advice of that regulator was rejected in favor of Congress's determination to set goals and standards of performance rather than attempt to substitute its business judgement for that of experienced managers and experts on the intricacies of the futures market. The consequence of that long-standing legislative decision is a successful and useful industry that is centered in the United States. There is no comparable favorable record for centralized governmental micro-planning for business. The Eastern Bloc is stark testimony to the bankruptcy of that approach.

The history of this industry provides a clear record of responsible interplay between the Congress, the CFTC and the exchanges. When the exchanges have been slow to achieve appropriate goals and standards, the Congress and the CFTC have applied the necessary pressure. The result of that pressure, in every case, has been to catalyze the industry to act and to create systems that achieve the goals without engaging either Congress or the CFTC in the detailed management of a highly technical and rapidly changing business.

Time and time again, self-regulation has proved the best method to reach the goals of market efficiency and integrity. For instance, in response to the CFTC's requirement that exchanges time transactions to the nearest minute, the CME called on the considerable experience and expertise that its members had accumulated in years of actual trading. The CME invested substantial sums in evaluating technologies and the alternative manual recordation techniques. The CME took account of its special needs, massive business flows, and the actual configuration of its trading pits.

The CME understood that a solution based solely on requiring brokers and traders to manually record transaction times would be inadequate and would potentially cost futures market customers much more in terms of greatly lessened market efficiency than any benefit they would likely derive. Instead, the CME, in conjunction with the Chicago Board of Trade, developed a Computerized Trade Reconstruction (CTR) system, of which the two primary benefits are minimal market disruption and primary reliance on information submitted from sources other than the objects of surveillance.

Through improvements in the CTR system, CME's surveillance system has continuously evolved to detect a wide range of trade practice abuses and to impute transaction times at a verifiable accuracy rate of 85% (as measured by the CFTC in our last review). CME Compliance Department staff continually facilitate the evolution of this system to keep pace with new trading strategies as they develop.

It would be extremely difficult, or perhaps impossible, for the Congress or the CFTC to make decisions at this detailed level. We expect that implementation of further enhancements suggested by the Special Committee to Review Trading Practices will increase the accuracy rate to well over 90%. I will outline these enhancements later in my testimony.

Another recent instance in which the CME independently initiated reforms in fulfillment of its self-regulatory role occurred with regard to the CME's then-most popular market, the S&P 500 Stock Index futures contract. As a result of this process, the entire transaction system for the S&P 500 futures contract was examined and revised. In what amounted to a dramatic break with status quo, dual trading was effectively banned from the CME equity futures contract by the adoption of the so-called "Top Step" rule which affected approximately 90% of public transactions in that market.

Also in 1987, the CME took a series of strong actions to enhance the effectiveness of its rule enforcement program. It hired, trained and placed Compliance Department staff in the trading pits on a full-time basis. The jobs of these investigators includes making observations that might discover improper conduct as well as following up on leads generated by the computerized portion of the surveillance system.

We enacted stringent rules requiring registration of broker associations and imposed limitations on their ability to trade between their members. We also created several programs to monitor compliance with these new rules and empowered a committee to enforce them.

At the same time, the CME greatly expanded the power of its Compliance Department. All members are required to submit to a tape recorded interview upon request. Members are required to produce requested books and records within thirty days or face charges of a major rule violation. A panel of experts was created to serve as consultants to Compliance Department staff in respect to esoteric or newly developed trading practices and schemes.

As another part of these reforms, we enacted a much harsher penalty structure and adopted a strict enforcement policy. The positive results of these actions were evidenced at this Subcommittee's last briefing session on June 28, 1989, when an investigator for this Subcommittee testified that the CME levied total fines of over $2.5 million, suspended membership privileges a total of 18,502 business days, and expelled 10 Exchange members in 1987 and 1988.

We believe that the above actions, which were taken independently of any regulatory requirement, are recent and strong testaments to the effectiveness of our self-regulatory system, as well as the wisdom of delegating the discretion respecting the methods to be used to meet rule enforcement goals to the exchanges themselves.

Disclosure that the FBI was conducting an investigation of futures traders activities on the Chicago and New York exchanges does not alter any of the foregoing. While this investigation may result in legal action against some of our members, it will not negate the fact that the CME surveillance system is effective and has an outstanding record, nor will it cast a doubt on the value and effectiveness of the self-regulatory process. Indeed, no surveillance system is fool-proof, nor is any industry completely free from its share of wrongdoers. Nevertheless, the vast majority of CME members are law-abiding and its system of surveillance second to none.

The CME continued its exemplary self-regulatory role in response to the FBI investigation. Within a week after disclosure of the investigation in January, 1989, we demonstrated our willingness to conduct a thorough self-examination of all trading practices. Toward this end, a Special Committee to Review Trading Practices was formed. The Special Committee was comprised of five public and industry participants as well as four Exchange officials. This Committee held lengthy hearings to receive testimony from scores of witnesses from all strata of the industry. In addition, scholarly works on market efficiency were consulted. This Congressional Subcommittee was informed of the recommendations announced by the Special Committee.

As this Subcommittee also knows, recently these recommendations were reviewed by a series of six internal CME committees comprised of a wide spectrum of CME members. The six internal committees -- Dual Trading, Broker Associations and Verbal Orders, Trading Surveillance, Disciplinary Practices, CTR Enhancements, and Admission Requirements-- have presented their recommendations to the CME Board of Governors which is now in the process of examining the recommendations.

As a result of this process, the wide-ranging and comprehensive changes recommended by the Special Committee have, in most instances, been accepted. In some cases, the CME internal member committee lessened the recommendations, but in other instances, recommended even further measures or equivalent or better alternatives to govern the area identified as a possible source of abuse by the Special Committee. The Board will now have an opportunity to review the package of recommendations. No doubt those recommendations between the Special Committee and the internal committee that are the same or similar will be endorsed. In those cases where the Board considers the recommendations of the Special Committee were lessened, the rationale of the internal committee will be carefully scrutinized in order to determine whether such lesser recommendations should be accepted. After Board consideration, those trading practice modifications which will have a substantial impact will be offered to the membership for ratification.

The following discussion of the issues raised by this Congressional Subcommittee incorporates the recommendations of the six internal CME review committees based on the recommendations of the Special Committee. Their contribution in terms of insight and institutional knowledge is invaluable and affirms the value of self-regulation.

DUAL TRADING

The ban on dual trading is the provision of the Bill most likely to draw public attention and debate. The prohibition springs from the conviction that the public's perception of dual trading in futures markets is strongly negative and the understanding that dual traders can prefer their own interests to the interests of their customers in clear violation of their duty. We have not found widespread concern about dual trading among the most substantial users of our markets. And, while we agree that dual traders are in a position to abuse their trust, the evidence so far accumulated does not suggest that dual trading is the principal culprit.

In our opinion, it is a serious mistake to require across-the-board restrictions on dual trading in all markets which have reached a daily average volume of 7,000 contracts as provided by the Futures and Options Regulatory Improvements Act of 1989. (Although the Bill uses the phrase "contract market" to compute the 7,000 contract threshold, we assume the Subcommittee really intended to apply the threshold to any contract month instead of all contract months combined. It is clear that no purpose consistent with the goal of the legislation would be served by refusing to recognize the reality that each contract month is a separate market. It is common for the volume levels between soon-to-expire months and back months to vary widely.) A prohibition based on an arbitrary average daily level of trade bears no relationship to the purpose sought to be accomplished. Moreover a single number cannot realistically be applied across the board where markets and market conditions are so varied.

The recommendations by the Special Committee to Review Trading Practices to prohibit dual trading in mature, liquid contract months reflected a compromise between the positive contribution of dual trading and its negative aspects and perceptions. In its rationale, the Special Committee recognized that dual trading is not inherently evil and "pervades financial markets, including cash markets, and the firms that deal for customers on those markets." It also recognized "that the practice of dual trading is a critical element insuring futures market liquidity."

When the internal CME Dual Trading Committee reviewed the foregoing recommendation, it concluded that the Special Committee's solution with respect to dual trading could be improved. If a methodology could be found that would sufficiently guard against those who would abuse dual trading while retaining the positive contribution of dual trading to liquidity, the CME markets would be better served. Furthermore, the internal Dual Trading Committee determined that a responsible and effective industry standard respecting the conditions under which dual trading would be permitted would better serve the long-run interests of the industry. Accordingly, the internal Committee on Dual Trading recommended the adoption of the following proposal subject to its acceptance by the CME Board of Governors, Congress and the CFTC. (In the event its proposal is found unacceptable, it recommended that the CME resume consideration of the Special Committee's recommendation.)

Dual trading will be allowed in any contract month in which the CFTC determines that the CTR system produces an audit trial of transactions that is verifiably accurate to the nearest minute at a 90% rate. If a contract month fails to meet that standard, then dual trading shall be prohibited with exceptions as proposed by the Special Committee, to wit: (1) brokers who have been given specific written authorization from every public customer for whom the broker fills orders; (2) brokers who are filling orders for other members of the Exchange; and (3) brokers who predominantly fill spread orders.

CME Compliance Department staff supported adoption of this proposal in light of the significant improvements to CTR and to the self-regulatory capabilities of the Exchange that will be implemented as a consequence of this reform process. Staff was satisfied that it could adequately enforce all rules respecting dual trading violations in any contract month where the 90% accuracy level is met. Staff also felt that the reference to the CFTC to authenticate compliance with the 90% level assured the substance of the program.

It is important to note that on July 11, 1989, the dual trading proposal of the CME's internal committee was presented for review to the Special Committee to Review Trading Practices. The Special Committee accepted the internal committee's recommendations as a fully adequate response to the pros and cons of dual trading. In its deliberations, the Special Committee took note that the balance between the contribution of dual trading to liquidity and the perceived dangers to customers is extremely delicate. Accordingly, the Special Committee unanimously agreed that the CME's internal committee's proposal is fully equivalent to its own original recommendation.

AUDIT TRAIL

The goal to reconstruct trading with a fully-verifiable audit trail which accurately reflects the sequence and time of trades so that all trading abuses are detectable is commendable, but unrealistic. The timetable which has been set to meet the requirements of 1-minute, 30-second and, in five years, real-time trade recordation ignores the physical realities of open outcry trading. There are no indications that technology will develop at a pace sufficient to make meeting these requirements possible in an open outcry market.

The important issue here is not whether you can achieve an abstractly perfect audit trail, but whether we can perfect a surveillance and punishment system that is highly effective in detecting and deterring trading abuses on the exchange floor. Surely you are all aware that no amount of money, effort or good faith can deter or discover and punish each and every rule violation.

We have not absolutely prevented our members and clearing members from violating our rules, CFTC Regulations or the law. During 1987 and 1988 the CME opened 260 trade practice investigations and secured convictions of 188 individuals. A large portion of these investigations and prosecutions were a direct result of information provided by our internal computerized surveillance system and floor monitors (23%) and by information provided by member and non-member informants (77%). The fines imposed by the CME in respect of such trade practice prosecutions since January 1, 1987, total $3,479,925.

We submit that these results are a clear indication of the CME's strict rule enforcement policy. They are the result of a tough stance against violators, one that compares favorably with any other futures exchange in the nation. Nor can it be argued that these results simply imply that there are more violators at our Exchange than at other exchanges. Such a cynical view has no basis in fact and runs contrary to logic which dictates that trade practices and ethics of members on all exchanges tend to be similar.

While these raw statistics respecting investigations and convictions are impressive testimony to the past efforts of the CME and its Compliance Department, they only tell but half of the story. A true assessment of a surveillance system requires that violations be graded according to their potential for harm to customers, the market, and other members. The first priority of the CME and its surveillance system has been to protect the public customers of its markets. Our most intense efforts and the bulk of our resources have been devoted to the protection of public customers.

We believe that our current systems have been highly effective in deterring, detecting and punishing rule violations that injure public customers of our markets. We are aware, however, that there have been a number of technical violations that have not injured customers that have gone undetected and unpunished. In particular, everyone connected with auction markets is aware that there is a certain amount of trading that continues after the final bell. The newspapers have had a field day with allegations about the horrors of "curb" trading. It is a technical violation and we do devote effort to preventing it, but it is not at the top of our list of enforcement priorities.

The open outcry system has in the past and continues to meet the mandate of the Commodity Exchange Act to contract markets to provide open and competitive markets. It demonstrates its efficiency every day. The unique chemistry of open outcry has operated to make our markets some of the most liquid in the world. Other countries have attempted to emulate this system because of this very quality. Our customers have demonstrated their overwhelming confidence in and support of our open outcry system by their trading decisions. Volume this year at the CME has increased by almost 40% over last year.

The alternative which we believe was intended to be furthered by this proposal is electronic trading. While we are in the forefront of developing an after-hour electronic system, we are convinced that electronic trading will not succeed without the liquidity provided by open outcry pit trading.

The stated goal of the audit trail proposal is to assure customers that U.S. futures markets are honest. Rather than helping U.S. exchanges to compete for business, this proposal will actually cripple these markets by overburdening participants to the extent that it will be nearly impossible for them to function efficiently, thereby destroying the liquidity that made them successful in the first place. It is well-known in the futures industry that the success of a market often depends on which of the competing markets attracts the most volume at the outset.

Instead of the above requirements, we believe that each exchange should be strongly urged to improve its surveillance and compliance trail systems. We believe it should be within the purview of each exchange to determine these enhancements but strongly recommend adoption of the CME's CTR system for purposes of improving the verifiable accuracy of trade timing in order to reach the standard required to be able to detect abuses which may be associated with dual trading.

The CME's internal review committees have recommended the following enhancements to our audit trail and surveillance systems:

- Report matched trade information on the trading floor for self-policing purposes. In addition to the information recommended to be displayed by the Special Committee, the CME review committee also recommended that customer type indicator and order type indicator information be included.
- Establish additional audit trail requirements so that verbal orders may be more accurately timed.
- Increase floor surveillance staff to provide greater coverage of all trading areas, particularly during market openings and closes and during periods of unusually active or volatile markets.
- Authorize additional investigative compliance staff.
- Conduct a study of the effectiveness of camera surveillance for specific trading practice investigations on the trading floor.
- Enhance the trade information database to assist staff review of out-trades.

- Institute opening and closing bracket indicators to distinguish trades occurring during these brief and active periods from other trades which occur during the first and last half-hours of trading.

- Require the pick-up of trading cards from members every two hours. If audit trail improvement goals are not met within six months, require that trading cards be picked up on an hourly basis. Currently, trading cards are collected twice daily.

- Implement 15-minute bracket periods. Currently, bracket periods last 30 minutes.

- Require uniform time-stamping of customer orders by clearing firms.

- Require floor brokers and traders to designate spread trades.

- In order to improve trade timing, require that order type information be submitted for all non-personal trades.

BROKER ASSOCIATIONS

The CME recognized that broker associations perform a valuable role in our markets, but can be a mechanism to facilitate trade practice abuses.

The CME instituted a system of broker association registration over five years ago and implemented trading restrictions among broker association members more than two years ago.

The CME's Special Committee to Review Trading Practices recommended and our internal Committee on Broker Associations has approved a similar set of Exchange restrictions on broker associations. Trading for a personal or proprietary account against a customer order will be prohibited among association members. Customer-to-customer order trading restrictions will be maintained at 25% of an association member's total volume in that contract.

PERIOD OF REAUTHORIZATION

We strongly support the proposal to establish the CFTC as a permanent agency. We agree that this will allow a more efficient allocation of agency resources and more concentrated efforts towards industry regulation.

UNDERCOVER SURVEILLANCE

We agree that undercover surveillance may help to deter and detect abuses. However, we strongly oppose undercover investigations that seek to induce wrongdoing in order to force the wrongdoer to testify against others who may be the real targets of investigators.

GOVERNING BOARDS

The CME internal Committee on Disciplinary Practices endorses the Special Committee's recommendation that members who have been convicted of a major offense be barred from serving on a disciplinary committee for a period of five years. In addition, it is also recommended that members convicted of minor rule violations be barred from disciplinary committee membership for three years.

Our Exchange has always enlisted public and industry governors to serve on our Board. This was the result of our judgment that this was an advisable business practice. The composition of its governing board is a business decision which exchanges arrive at for competitive reasons. This is another area that should be left to the discretion of the individual exchanges. It is not appropriate in this context for Congress to substitute its business judgment for the judgment of the institutions that are actually competing.

TELEMARKETING FRAUD

We agree with the testimony that this Subcommittee has received that telemarketing fraud in the futures industry occurs in only a very small percentage (less than 1%) of all transactions. We believe that where these practices do occur, they have a disproportionate negative reflection on the industry as a whole and must be prevented to the extent possible without hindering legitimate retail trading.

Currently, the industry must comply with an extensive set of rules respecting sales practices that have been adopted by the CFTC and the National Futures Association. In addition, the CFTC has recently directed that each exchange develop additional procedures for assuring that sales practice audit and investigative programs adequately address the issue of detecting abusive oral sales representation. The CME, for example, has decided that its Compliance staff will pose as customers over the telephone in attempting to ascertain which firms are engaging in fraudulent or high-pressure oral sales solicitations.

We believe that existing methods coupled with enhanced programs will sufficiently deal with the problems that this proposal is attempting to solve, but without the accompanying recordkeeping burdens that will be placed on firms to demonstrate compliance with the regulation.

DISCIPLINARY COMMITTEES

We strongly oppose the imposition of composition requirements on exchange disciplinary committees. The CME's Special Committee already has made a thoughtful recommendation on this subject which has been ratified by the internal Committee on Disciplinary Practices.

It would be rash of Congress to mandate change in the absence of a documented failure of the current disciplinary committee system. As the testimony heard by this Subcommittee at its last briefing session bears out, the CME's and other exchanges' disciplinary committees act fairly. At the CME, many safeguards are in place to prevent a member who has a financial interest in the adjudicated matter from hearing a case. Also, deliberations are conducted confidentially, so that a member need not fear retribution for his decision.

The CME's internal committee on Disciplinary Practices has endorsed the Special Committee's proposal to add one knowledgeable non-member to each Exchange disciplinary committee panel. This proposal has been structured to retain the trading expertise necessary to a committee deliberating possible trading practice abuses while injecting impartial participation by a knowledgeable outsider. We believe that, in our case, this is the best remedy for the perceived problem that disciplinary committees have a bias in favor of Exchange members against non-members or show favoritism to influential members. However, we believe that this is another area in which each exchange should exercise its discretion.

However, if some regulatory requirements in this area are deemed absolutely necessary, the CFTC is in a far better position than Congress to act if change is necessary. The CFTC already has the tools necessary to do this.

REGISTRATIONS

The CME's Special Committee recommended and the CME internal committee on Admission Requirements has approved a proposal whereby floor traders would be required to register as floor brokers in order to get FBI fingerprint checks.

ETHICS TRAINING

The CME's Special Committee recommended, and the CME internal Committee on Admission Requirements has ratified, a mandatory ethics program for new and existing members which would encompass trading rules, federal and administrative sanctions for rule violations and their ethical responsibilities thereunder. In addition, it is being recommended that our members be reminded of their ethical responsibilities periodically.

GLOBEX

Allow me now to digress a bit from the foregoing discussion relating to floor practices. Indeed, if the emotional impact of the dual trading issue or the other issues relating to floor practices were not of such overriding moment, my testimony would have begun, rather than ended, with a reminder that the CME has spent the better part of the last two years creating and implementing its global electronic trading system -- GLOBEX.

The CME and Reuters Limited are developing GLOBEX as an electronic communications network and order matching system that can be used by members of an exchange to trade its futures and options contracts during the hours that the exchange's trading floor is closed. GLOBEX will allow transactions in futures, options, and selected foreign financial instruments to be executed from anywhere in the world, instantly, and with financial integrity.

It is of immediate concern to us that the Bill fails to acknowledge the existence of electronic trading systems which guarantee perfect audit trails. The prohibitions that are attached to pit trading are equally attached to trading on the electronic system. Again, we are confident that this is the product of the time pressure under which the Bill was prepared. No matter what form Sections 101 and 102 take, they need to exclude trading on electronic systems with inherently perfect audit trails.

That much is obvious, but the creation of GLOBEX by the CME and of AURORA by the Chicago Board of Trade has a significance that seems to have been all but overlooked when the philosophy of the Bill was formulated. It is absolutely and unequivocally clear that the exchanges were at the forefront of a monumental innovation with enormous regulatory and far-reaching business consequences. The exchanges moved to implement better audit trails and to afford their customers markets of unquestionable integrity without threat of legislative action, without administrative spurring, and without the prodding of the U.S. Attorney. We acted because we were driven by competition, had the courage to make hard decisions, and were able to move without awaiting either a legislative or administrative initiative.

The CME concluded that the most important trend affecting securities markets and capital formation is the acceleration toward international markets. Capital moves across national boundaries with increasing ease, reflecting both enhanced opportunities and sophistication on the part of investors to exploit the opportunities. The CME's initial reaction to this trend was to develop foreign currency and Eurodollar futures and options. Most recently, the development of GLOBEX acknowledges that the mechanism of trading needs to fit the international community as seamlessly as the instruments traded.

Steps to keep our economy in a position to benefit from this trend must be made today, or the United States may lose its place of pre-eminence in the world capital markets. Private U.S. firms have demonstrated an ability to move quickly and effectively in this environment, but regulatory burdens should be addressed promptly.

Trading can be done in London or Tokyo as easily as in Chicago or New York. In the last five years, new futures exchanges have opened or been announced in London, Paris, Hong Kong, Sydney, Toronto, Singapore, New Zealand, Brazil, Osaka, Zurich, Tokyo, Dublin, Frankfurt. Every financial center knows the value of integrating actual or possible movement of London's FTSE 100 and Tokyo's NIKKEI indices as harbingers of the days' S&P 500 movement.

Regulation of securities and futures markets internationally has shown little consistency across national boundaries. While regulation should be adequate, great care must be taken that our regulations do not place unnecessary constraints on the U.S. securities and futures industries. Many instruments are traded at several different locations around the world, and regulatory inequities could chase U.S. business to foreign markets.

CONCLUSION

The Chicago Mercantile Exchange is firmly committed to meeting its self-regulatory responsibilities. We believe that our record of achievements in this area is well documented. In addition, we believe that the process by which we are examining the entire scope of our trading rules in a very thorough and thoughtful manner meets the highest goals of self-regulation.

We recognize that our customers have interests in market integrity, efficiency and liquidity and we take our obligations to safeguard these interests very seriously. Through the examination of our rule enforcement system, we have sought to structure recommendations to further market integrity with a minimum of market disruption. We believe that only by allowing U.S. futures exchanges to determine market-efficient measures to meet their self-regulatory responsibilities will the U.S. futures industry continue to enjoy its pre-eminent role among all futures markets worldwide.

I would like to thank this Subcommittee again for the opportunity to comment on these very wide-ranging proposals. Of necessity, my comments have been long and technical in nature. I would be pleased to answer any questions you may have.

APPENDIX

Sec. 101. Dual Trading

The direction to the CFTC to issue regulations to ban dual trading in certain circumstances fails to account for the clear differences between pit-based trading and trading done by means of an electronic order execution system such as the CME's GLOBEX. GLOBEX does not make use of floor brokers who operate in an analogous fashion with the pit-based system; however, many GLOBEX terminal operators may hold floor broker registration. We submit that the legislation needs to be redrafted to distinguish among trading systems.

In our opinion, a dual trading ban based on an arbitrary numerical threshold is inappropriate. The theory underlying the legislation is that volume equates to liquidity and therefore a significant volume level guarantees the liquidity necessary to ban dual trading without adverse market impact. The rationale underlying such a principle is faulty. Liquidity cannot be measured solely in terms of average volume, but rather in terms of the ability of the market throughout the trading day to allow the prompt execution of orders without causing undue price gaps.

Reliance solely on a volume number fails to take into account the distinct and highly relevant variables among markets. If order flow to a particular market is even and of a relatively uniform size, then a contract month that averages 7,000 contracts per day may be sufficiently developed so that a ban on dual trading will have only a slight impact. However, if a market has the opposite characteristics, namely uneven order flow and widely disparately sized orders, then 7,000 contracts per day is no indication that the contract can survive the elimination of dual trading. Simply stated, each market has its own idiosyncracies. Every contract market -- soybeans, cattle, gold, interest rates, oil, cocoa -- has a distinct user community of commercial hedgers with different volume needs that change over time. There is no uniform appropriate volume threshold that transfers from commodity to commodity or exchange to exchange.

The Bill applies the volume threshold to the "contract market" as an entirety, ignoring the different circumstances of various "contract months." Thus, if the active month trades 6,500 contracts per day and an inactive month trades 500 and only has two brokers and two local traders, the Bill would bar dual trading across the board and severely restrict competition in the less active month.

The Bill also sets forth an unworkable test for the CFTC to increase or decrease the threshold trading level. The CFTC is called upon to determine that the prohibition against dual trading "creates undesirable price volatility, widening of the bid-ask spread, or otherwise threatens the public interest." It is highly unlikely that the CFTC can or would devote the resources to perfecting a test that will be able to isolate the impact of dual trading in this context. That being the case, this language encourages litigation on any occasion the CFTC would diverge from the artificial threshold.

The Bill's exemption from the prohibition on dual trading based on the soundness of the audit trail is correct in concept but imperfectly applied. The Bill requires that the audit trail "detect any and all instances of trading violations" and further requires that the audit trail be "fully verifiable." These are impossible standards. Perfection is not attainable in the futures industry nor any other. Detection of "any and all" instances of wrongdoing is an unreasonable standard that can never be met.

The exemptions are not complete. There is good reason to allow a member on the floor to give his order to any broker he chooses, including a broker who trades for his own account. There is no reason to require the formality of a written form in order to permit this practice. The restriction of a broker's ability to trade out of his errors to the next day's opening is disastrous. A broker who makes an error must be free to immediately trade out of the position. No one could afford to act as a broker if required to hold positions assumed in error until the next day's opening.

The exemption for spread brokers is insufficient. The exemption is needed to protect spread brokers that attempt to fill an order and complete only one side of the spread. That position then belongs to the broker. If spread brokers were unable to "leg on" by buying one side at a time in the hope of then getting the rest of the spread, customers would suffer serious consequences.

Sec. 102. Trading Among Members of Broker Associations

We commend the purpose of this section, which is to clarify that just as it is wrong for an individual floor broker to "front-run" or in any method abuse a customer trade by dual trading, then the same should be prohibited for broker associations. However, the legislative language sets forth serious unintended consequences.

The CFTC is directed to establish regulations that are incompatible with the developing electronic trading systems, such as GLOBEX. Certain members of a broker association, one trading for a customer, another trading for his own account, could in fact take opposite sides of a transaction, and unbeknownst to themselves be automatically matched in the GLOBEX system. While they are members of an association, no wrongdoing can occur in the GLOBEX system which is totally neutral to who is matched in trades, rather it does it on a price and time sequence basis.

Further, the Bill would impose an artificial legislated percentage point as an appropriate transaction threshold prohibition. The objection is not that the 25% is inappropriate, but rather that it is inadvisable to put in place any percentage in law. The flexibility to determine an appropriate percentage threshold should exist so that it can be relaxed, or made more stringent, as conditions warrant. The Bill should set forth the purpose to be accomplished, and direct the CFTC to require the exchanges to adopt appropriate rules to meet that goal. This would provide for the flexibility to deal with the changes in technology, and to consider the benefits extant with broker associations, specifically the combination of greater capitalization, and a continuing long-term commitment to the brokerage business.

TITLE II. ENHANCEMENT OF REGULATORY ACTIVITIES

Sec. 201. Audit Trails

Our principal objection to this section is that it demands a result without reference to the value of that result and the consequences of achieving it. The goal is a verifiable audit trail effective in deterring and detecting abuses. Mandating thirty-second time accuracy within three years is not the way to that end. The CFTC should be allowed to determine an acceptable threshold of verifiability, and we should recognize it may change over time.

Section 201 should thus delete sec. 201(a)(2)(B)(ii)(b).

Sec. 201(b) requiring that "every contract market" complies with the specifically delineated audit trail requirements as a condition of designation is over broad. The language would apparently require either immediately ceasing all futures trading until each exchange demonstrated that it is in compliance, or require the CFTC to so assert compliance. The CFTC has the current authority to revoke any contract market designation if it finds surveillance inconsistent with the Act.

Sec. 202. Telemarketing Fraud

Sec. 202(a) should be revised to direct the CFTC to accomplish appropriate regulations and set forth the customer protection goals.

Sec. 203. Undercover Operations and Enforcement

This language is redundant. This is made clear by the phrase "the Commission shall continue" the precise authority this section delineates. The CFTC has the authority to cooperate with appropriate Federal agencies and has done so. All CFTC employees are prohibited from trading futures contracts, which is appropriate, and thus it does not have, nor should it have, the ability to conduct undercover investigations. That is the purview of the FBI, and obviously that is the status of the current law.

Thus Sec. 203 should be stricken. Any discussion of undercover operations, and the Commission's cooperation with same, can be part of legislative report language.

Sec. 204. Self-regulatory Organization Disciplinary Committees and Governing Boards

The CFTC has the authority to conduct a rule-making on the structure of disciplinary committees. That is the appropriate method for determining what, if any, improvements are necessary. The Bill attempt at committee restructuring is based on a premise that is without evidence; i.e., that the current disciplinary structure is flawed. Further, Bill language requiring that staff members of the exchange serve on disciplinary committees is a serious error. CME staff are employees of the Exchange and should not be the judges of the members. Further, the requirement that the committee be composed of a majority of persons of a different trading status than the respondent is totally unwarranted and unworkable. Members are traders, and virtually all disciplinary committees, by their nature, involve members disciplining members who are of the same trading status. Committees should be composed of experts who understand their responsibility to ensure markets are honest.

The CFTC presently has the power to effectively establish and administer a rule enforcement program. The CME and other exchanges currently publish accurate descriptions of the context that was the basis of a rule violation. These are prominently posted outside of the trading floor. There is no evidence that what constitutes a major violation is unknown.

Penalty guidelines for rule violations involving financial injury to public customers are important. The CME Special Committee recommended severe penalties, including suspension of membership privileges and expulsion. When membership has been suspended, the individual is unable to serve on disciplinary or governing committees of the exchange, and thus the legislative language is redundant.

The recommendation of a legislated certain percentage for the number of outside governors for a board is inappropriate. This is a business judgment. Corporate governance discussions today often urge a broader representation of outside directors and/or a concomitant limit to the number of officers on a board of directors. However, just as there is no statutory requirement on this under the securities laws, nor should there be under the C.E.A.

Sec. 205. Required Registration of Floor Traders

We endorse the concept of registering floor traders. The principal purpose for doing so is to obtain the FBI fingerprint check helpful to enhance a thorough background review of the individual trader. However, the Bill language specificity causes concern. By example, the Bill's definition of "floor trader" could be misconstrued in a GLOBEX-AURORA electronic trading scheme. In short, regulatory flexibility for "floor trader" registration would be better accomplished under rule-making.

We oppose amending sec. 4(g)(1) of the C.E.A. instituting unnecessary record keeping burdens on floor traders.

We endorse sec. 205(e) furthering the applicable exemption of contract markets, clearinghouse, floor brokers, or floor traders from the appropriate exemption of jurisdiction by the states.

We similarly endorse the remaining appropriate conforming amendments in Sec. 205.

Sec. 206. Enhancement of Registration Requirements

The CME generally agrees that registration requirements should be tightened, but refers you to the testimony of Robert K. Wilmouth, President, National Futures Association, on this topic. The NFA has, since 1985, assumed the registration responsibilities for the futures industry.

Sec. 207. Enforcement of Civil Money Penalties

We endorse amending the Act to delete the requirement that financial considerations of the violator and his ability to continue in business need not be part of the consideration for assessing the fine, restricting penalties solely to the gravity of the violation. However, we question the appropriateness of a mere fifteen day period for accomplishing full payment. This has vestiges of imprisoning debtors for inability to pay. Accepting the importance of receiving full payment and interest thereon, flexibility for procedures to ensure that payment can be accomplished would seem more sensible. The same analysis applies to the thirty day requirement subsequent to appeals. We endorse the concept of expanded efforts toward collection for those who fail to pay, but believe the time frame for accomplishing payment should be significantly broadened; e.g., six months, with interest to commence accruing after fifteen days.

Sec. 208. Ethics Training for Registrants

We endorse a rule-making on establishing ethics education.

Sec. 209. Nationwide Service of Process and Venue

We endorse this jurisdictional broadening.

TITLE III. ASSISTANCE TO FOREIGN FUTURES AUTHORITIES

We endorse the following sections, recognizing the globalization of futures trading, and the need for cooperation among regulatory counterparts:

Sec. 301. Definition of Foreign Futures Authority

Sec. 302. Subpoena Authority

Sec. 303. Cooperation with Foreign Futures Authorities

Sec. 304. Investigative Assistance to Foreign Futures Authorities

We endorse this section requiring cooperation. However, we note that the CFTC is only required to "consider" whether reciprocal cooperation exists, when it determines whether or not to provide assistance, and further to only "consider" whether the request would prejudice the public interest to the United States. The CFTC is in a better position than an exchange to evaluate this language.

Sec. 305. Disclosure of Information Received from Foreign Futures Authorities

We endorse the requirement that the CFTC not be compelled to disclose any information obtained from a foreign futures authority. However, we believe the Bill's exceptions to this disclosure protection are too broad. We would restrict disclosure to exclusively administrative or judicial proceedings, receivership or bankruptcy proceedings to which the CFTC has a right to appear. However, we recommend limiting such disclosure to a congressional proceeding. Violations of confidentiality in congressional proceedings are unfortunately a well-known fact, and that possibility could inhibit foreign futures authorities from cooperating.

Sec. 306. Disclosure of Information to Foreign Futures Authorities

We endorse these provisions.

TITLE IV. AUTHORIZATION OF APPROPRIATIONS; EFFECTIVE DATE

Sec. 401. Authorization of Appropriations

We support the provision making the CFTC a permanent agency on full equivalent status with the SEC. We support this provision which discontinues the three or four year reauthorization.

TESTIMONY OF ROBERT K. WILMOUTH
PRESIDENT
NATIONAL FUTURES ASSOCIATION

BEFORE THE HOUSE AGRICULTURE SUBCOMMITTEE
ON CONSERVATION, CREDIT, AND RURAL DEVELOPMENT
RE: H.R. 2869

Chairman English, Distinguished Members of the Subcommittee, Ladies and Gentlemen.

I. INTRODUCTION

My name is Robert K. Wilmouth and I am the President of National Futures Association. NFA welcomes this opportunity to present its views on the proposed legislation pending before this Committee. The issues involved are both complex and important. Congress must once again perform a difficult balancing act. On the one hand, Congress must provide sufficient regulation to ensure the fairness of and public confidence in U.S. futures markets. On the other hand, Congress must avoid unduly burdensome regulations which could impair the efficiency and usefulness of those markets and erode the position of U.S. markets in an evermore competitive global marketplace.

From its unique position in the regulatory structure of the industry, NFA may have a somewhat different perspective than some of those who will testify before you. As envisioned by Congress and implemented by our Board, NFA was never intended to duplicate, and has not duplicated, the regulatory efforts of the exchanges. NFA's authority, therefore, focuses not on exchange trading floors, but on all other aspects of its Members' dealings with the public. NFA's primary responsibilities include:

- developing and enforcing customer protection rules to ensure that Members observe the highest possible ethical standards in their business and sales practices;
- preventing unethical firms and individuals from entering the industry by performing the registration function on behalf of the Commission;
- protecting customers by educating them about the futures markets and their risks so that customers can make fully informed investment decisions; and
- providing customers with an arbitration forum which provides a fair, prompt and inexpensive means of resolving disputes.

NFA's accomplishments in each of these areas since the last reauthorization have been detailed in a lengthy report we have previously provided to each of you. The Executive Summary of that report is attached to my written submission.

Certain of the proposed amendments to the Act that you are considering would directly impact NFA in carrying out our regulatory responsibilities. I would like to comment on those proposals with some specific observations. Other issues you are dealing with may not directly impact NFA but could have a profound impact on the futures industry. On those issues NFA is a very interested bystander and I would offer more general observations on those points.

II. DUAL TRADING/AUDIT TRAILS

Two of these issues which do not directly concern NFA involve dual trading and audit trails. Audit trails do not directly affect NFA since we do not operate a marketplace. I would only note in passing that in considering whether to require further improvements to exchange audit trails, Congress must not lose sight of the progress which has already been made in this area. The trade reconstruction capacity of the exchanges is now vastly superior to what it was just a few short years ago, and in most contract months the exchanges can reconstruct trading activity with 90% accuracy. That is not to say that further improvements should not be made. But the one thing which the various investigations into the October 1987 crash proved conclusively was that the audit trails in the futures markets set the standards for other markets to match.

With respect to dual trading, I suppose the only statement that everyone would agree with is that this issue is extraordinarily complex. None can deny that public confidence in the U.S. futures markets is critical to the continuing success of those markets. That public confidence is based on both the integrity and efficiency of those markets.

The integrity of those markets has been called into question by some because the practice of dual trading can create the appearance of customer abuse. And when you are dealing with public confidence, appearances can be as important as reality. However, in deciding whether to maintain public confidence by regulating the practice of dual trading, Congress must move with great caution.

Public confidence is important to the markets but no more so than market efficiency. That efficiency depends on the liquidity offered by U.S. futures markets, liquidity which is the envy of all of our world competitors. Dual trading makes an important contribution to that liquidity and any legislative action which could affect market liquidity, the cornerstone of our efficient markets, should be approached with great caution. This is particularly true in trying to design a solution which would apply not just to one contract or to one exchange but on an industrywide basis. A second point to consider is how the concerns over potential abuses in dual trading can be addressed through improved audit trails. As this bill recognizes, the better the audit trail to detect actual abuses, the less the public concern over potential abuses and the less the need for a ban on dual trading. The bill provides that the ban on dual trading would be lifted when an exchange's trade reconstruction is 100% accurate. But given the importance of dual trading to the efficiency of our markets and the inevitability of human error, Congress must consider whether a trade reconstruction standard of absolute perfection is more demanding than necessary and, perhaps, unobtainable.

The issues are difficult, the stakes are high and Congress should take great care to hear all of the interested parties, learn all of the relevant facts and consider all of the possible ramifications before taking any final action.

III. REGISTRATION REQUIREMENTS

One of the best ways to protect the public from unscrupulous firms and individuals is to keep those people out of the industry in the first place. That is the job that NFA has been handling since October 1, 1985, when it assumed responsibility for denying, revoking, restricting or conditioning registration for all categories except floor brokers and leverage transaction merchants. NFA has done that job by applying the two-tiered system of disqualifications from registration which Congress established in 1982. Sections 8a(2) and 8a(3) of the Act have proved to be effective tools in maintaining the high fitness standards of the futures industry, but NFA agrees with the Committee that those provisions can be fine-tuned and improved. NFA strongly supports the proposed amendments.

In general, the proposed amendments will tighten the fitness standards of the futures industry. At the same time, the suggested amendments retain the critical distinction between the more egregious disqualifications set forth in Section 8a(2) of the Act and the less serious disqualifications set forth in Section 8a(3) of the Act.

The proposed amendments would also codify certain of the Commission's and NFA's prior interpretations of the existing disqualification provisions and would resolve certain ambiguities in the Act which NFA has encountered over the past few years.

To summarize, it is NFA's view that the proposed amendments to the disqualification provisions of the Act will strengthen the fitness standards of the futures industry, promote fairness and uniformity of treatment among similarly situated applicants and registrants and further serve to streamline and simplify registration disqualification proceedings. A more detailed analysis of NFA's support of the proposed amendments is set forth below.

Section 8a(2)(C)(ii) of the Act

At the present, Section 8a(2)(C)(ii) of the Act provides, in pertinent part, that a person is disqualified from registration if he is permanently or temporarily enjoined from "engaging in or continuing any activity involving any transaction in or advice concerning contracts of sale of a commodity for future delivery...or concerning securities." The language used in Section 8a(2)(C)(ii) is rather broad. Theoretically, Section 8a(2)(C)(ii) of the Act disqualifies a person or firm which is enjoined from simply engaging in certain futures or securities recordkeeping violations. Further, this Section of the Act arguably disqualifies from registration persons and firms who, though subject to a permanent injunction involving securities, nevertheless obtained or retained registration from the Securities Exchange Commission, the National Association of Securities Dealers or a state securities commission, which initiated the injunctive action.

At the same time, Section 8a(2)(C)(ii) of the Act is perhaps too narrowly drafted. It covers only injunctions involving futures or securities. As currently written, Section 8a(2)(C)(ii) does not include injunctions which, although not involving futures or securities, nevertheless involve serious wrongdoing. For example, state insurance or state gambling commissioners may obtain court orders enjoining wrongful conduct. However, such injunctive orders are not covered currently by Section 8a(2)(C)(ii) of the Act.

NFA favors the proposed amendments to this provision which encompass the most serious types of injunctions, regardless of whether such injunctions involve futures or securities, such as those involving theft, fraud, fraudulent conversion, misappropriation of funds, securities or property, false pretenses and deception of customers. NFA also supports the proposed amendments which explicitly create an exception for injunctions which are not deemed to constitute disqualifications from registration by the regulatory agency which initiated the injunctive action. NFA anticipates that if these proposed amendments are adopted, it will be able to concentrate its efforts and resources on more serious injunctions, rather than spend time on matters which are of a de minimis nature or which the primary regulator did not regard as constituting a disqualification from registration.

Section 8a(2)(D) of the Act

At present, Section 8a(2)(D) of the Act provides that certain types of serious felony convictions within the last ten years qualify as disqualifications from registration. NFA agrees with the Committee that Section 8a(2)(D)(iii) of the Act can be strengthened by including felonies which involve deception of customers. In NFA's view, such felonies bear directly on a person's fitness for registration.

NFA also favors amending Section 8a(2)(D)(iv) of the Act to include serious felony offenses under other sections of titles 18 and 26 of the United States Code. Virtually every criminal federal case involving commodities or securities includes violations of one or more of the following federal criminal statutes which are not currently included in Section 8a(2)(D)(iv) of the Act:

1) 18 U.S.C. § 1001 (false statements);
2) 18 U.S.C. § 371 (conspiracy);
3) 26 U.S.C. §§ 7201 and 7206 (tax evasion and tax fraud);
4) 18 U.S.C. § 1503 (obstruction of justice);
5) 18 U.S.C. § 1623 (perjury);

6) 18 U.S.C. § 2314 (interstate transportation of stolen property); and
7) 18 U.S.C. §§ 1961-1963 (racketeering).

NFA contemplates that Section 8a(2)(D)(iv) will be significantly strengthened if these serious felony convictions are added to the list of disqualifying offenses.

Section 8a(2)(E) of the Act

Section 8a(2)(E) of the Act currently disqualifies persons who have been found to have violated certain serious provisions of a number of specified federal and state statutes and the regulations, rules or orders thereunder. The Commission has indicated in an interpretive notice that, as currently drafted, Section 8a(2)(E) may be interpreted to authorize the Commission to affect the registration of a person subject to findings described in such Section, which are made in a proceeding initiated by a private party either in a court of law or in a reparations matter. The Commission has indicated, however, that such private litigation is intended primarily to provide restitution to the customer and is not intended to be punitive in nature. Thus, the Commission has decided that it may be inappropriate to use findings in such proceedings to affect the registration of any person under Section 8a(2)(E) of the Act. However, the Commission has made it clear that such findings may be used to initiate a disqualification proceeding under Section 8a(3)(M) of the Act. See Appendix A to Part 3 of the

Commission Regulations, 1 Comm. Fut. L. Rep. ¶2220L at 2346 (1984).

NFA supports the proposed amendments to Section 8a(2)(E) which would codify the Commission's interpretive statement on this Section. The proposed amendments restrict this Section's applicability to administrative proceedings brought by the Commission, or any federal, state or other governmental body. NFA also supports amending Section 8a(2)(E) to include violations of the Racketeer Influenced and Corrupt Organizations Act ("RICO"). NFA shares the Committee's view that violations of RICO are as serious, if not more so, than certain of the violations of the statutes currently enumerated in Section 8a(2)(E).

Furthermore, NFA favors amending this Section to include violations which involve deception of customers. This language, which tracks the proposed amendment to Section 8a(2)(D)(iii) of the Act, would encompass violations which bear directly on a person's fitness for registration, but which may fall outside the parameters of Section 8a(2)(E) of the Act as currently drafted.

Section 8a(2)(G) of the Act

Section 8a(2)(G) of the Act disqualifies from registration any person who willfully makes any false or misleading statement or omitted to state any material fact in his registration application with respect to matters set forth in Sections 8a(2)(A) through (F) of the Act. NFA supports the proposed amendments to this Section which would disqualify any person who makes any willful material omission or misleading statement concerning any disqualification under either Section 8a(2) or Section 8a(3) of the Act.

It is well-established that NFA's fitness determinations depend, in part, on full disclosure of all material information. NFA agrees that it is highly inappropriate to allow an applicant to obtain a temporary license or for a registrant to remain registered, who has failed to disclose the fact that he may be subject to a statutory disqualification. The inappropriateness of allowing a deceptive person to obtain or retain registration does not lessen because he may be subject to a Section 8a(3) rather than a Section 8a(2) disqualification. NFA believes that Congress can underscore the importance of full disclosure on registration applications and amendments thereto by adopting the proposed changes.

NFA also supports the proposed amendments which make it clear that omissions and misleading statements in updates to registration applications will disqualify a person from registration.

Section 8a(3)(D) of the Act

Section 8a(3)(D) of the Act disqualifies from registration persons convicted of felonies other than the type specified in Section 8a(2)(D) of the Act within ten years of filing a registration application, as well as persons convicted of Section 8a(2)(D) type felonies more than ten years preceding the filing of an application.

NFA favors amending Section 8a(3)(D) to include not only situations where a person has actually been convicted of a felony, but also those instances where a person pleads guilty to such offense, even though not formally convicted.

In August 1988, NFA adopted the policy of initiating a disqualification action under the "other good cause" provision of Section 8a(3)(M) against persons who pleaded guilty to a felony, although adjudication was withheld. NFA instituted this policy because it determined that a person who pleaded guilty to a felony may be unfit to be registered, regardless of whether or not he was formally convicted. NFA was concerned that such person's treatment under the Act not be contingent upon the vagaries of particular states' laws.

The proposed amendment to Section 8a(3)(D) will codify NFA's practice of initiating disqualification proceedings against persons who have pleaded guilty to a felony offense even though they have not been formally convicted. NFA expects that the proposed amendment will have the effect of promoting uniformity of treatment among similarly situated persons.

NFA also supports the Committee's proposal to eliminate the ten-year limit on felony convictions other than the type specified in Section 8a(2) of the Act. Currently, in appropriate cases, NFA initiates actions against persons who have been convicted of felonies other than the type specified in Section 8a(2) more than ten years ago, under the "other good cause" provision of Section 8a(3)(M) of the Act. NFA agrees with the Committee that a person's felony conviction, regardless of its age, bears directly on a person's fitness for registration and therefore favors eliminating the ten-year limit contained in Section 8a(3)(D).

NFA recognizes that the presumption of unfitness arising from such a conviction or guilty plea may well be less than that arising from a more recent conviction. Moreover, it may very well be that a person with an older felony conviction or guilty plea may be able to present more substantial rehabilitation evidence than someone who had pleaded guilty or had been convicted of a felony more recently. However, it is NFA's view that these factors relate to the issue of what weight should be accorded such conviction or guilty plea, not whether such conviction or guilty plea constitutes a disqualification in the first place.

Section 8a(3)(E) of the Act

Section 8a(3)(E) of the Act disqualifies from registration persons who have been convicted of certain serious misdemeanor convictions within the past ten years. NFA supports the Committee's proposal to amend Section 8a(3)(E) by eliminating the ten-year time limit and by including instances where a person pleads guilty to a misdemeanor offense, although not formally convicted. These proposed amendments parallel those suggested under Section 8a(3)(D) of the Act.

The proposed changes to Section 8a(3)(E) would serve to codify NFA's practice of initiating cases under Section 8a(3)(M) of the Act, against persons who, although not formally convicted, pleaded guilty to serious misdemeanors and against persons whose serious misdemeanors are over ten years old. NFA expected that the proposed amendments will promote uniformity of treatment among similarly situated persons.

NFA also supports the proposed amendments to Section 8a(3)(E) which add to the list of serious misdemeanors those involving deception of customers, moral turpitude and conduct inconsistent with just and equitable principles of trade. NFA also favors supplementing the list of statutes currently enumerated in Section 8a(3)(E) to include those involving conspiracy, tax evasion and tax fraud. NFA agrees that adding these kinds of serious misdemeanors to Section 8a(3) will significantly strengthen the reach of that provision.

Section 8a(3)(G) of the Act

Section 8a(3)(G) of the Act disqualifies from registration a person who willfully makes any materially false or misleading statement or who willfully omits to state any material fact in such person's application, in any report required to be filed with the Commission, or in any proceeding before the Commission. In view of the fact that NFA also conducts registration disqualification proceedings, NFA agrees that it is appropriate for the Committee to adopt amendments to Section 8a(3)(G) of the Act which will encompass willful omissions or materially false or misleading statements made by a person in the course of a disqualification proceeding conducted by NFA. NFA also supports the proposed amendment that makes it clear that omissions and false and misleading statements contained in updates to a person's registration application will constitute a disqualification from registration.

Section 8a(3)(H) of the Act

Section 8a(3)(H) of the Act disqualifies from registration persons who have pleaded nolo contendere to criminal charges of felonious conduct, or who have been convicted in a state court or in a foreign court of conduct which would constitute a felony under federal law if the offense has been committed under federal jurisdiction. NFA supports the proposed amendment to Section 8a(3)(H) which would broaden this provision to encompass convictions in United States military courts of offenses regarded as felonies under federal law.

It has been NFA's experience that United States military courts, like certain state and foreign courts, do not always explicitly distinguish between felony and misdemeanor offenses. Thus, it seems appropriate to include a reference to such courts in Section 8a(3)(H) of the Act.

In the past, NFA has initiated under the "other good cause" provision of Section 8a(3)(M) of the Act, an action against a person who was convicted in a United States military court of an offense which would be considered a felony under federal law. The proposed amendment would codify NFA's practice in this regard.

Section 8a(3)(J) of the Act

Section 8a(3)(J) of the Act currently disqualifies from registration persons who are subject to an outstanding order denying, suspending, or expelling such person from membership in a contract market, a registered futures association, or any other self-regulatory organization ("SRO"), or barring or suspending such person from being associated with any member or members of such contract market, registered futures association or SRO.

NFA favors amending Section 8a(3)(J) of the Act to include as disqualifications from registration denials, bars, suspensions and expulsions from foreign regulatory organizations which the Commission has recognized as having a comparable regulatory program to that of the Commission's. The proposed amendment will prevent persons who have been severely sanctioned by foreign regulatory bodies from obtaining registration under the Act.

Section 8a(3)(K) of the Act

Section 8a(3)(K) of the Act disqualifies from registration persons who have been found by any court of competent jurisdiction or by any federal or state agency or other governmental body, or by agreement of settlement to which any federal or state agency is a party to have violated any statute, rule, regulation or order thereunder which involves a serious offense such as embezzlement, theft, extortion, fraud and the like. NFA supports amending Section 8a(3)(K) of the Act to include other serious offenses such as deception of customers and conduct inconsistent with just and equitable principles of trade. NFA agrees with the Committee that the proposed amendment will serve to tighten the requirements contained in Section 8a(3)(K).

I have just one final point regarding registration. If Congress decides to require the registration of floor traders, I can assure you that NFA would be capable of assuming that processing function if requested to do so.

IV. TELEMARKETING FRAUD

No job is more important to NFA than the prevention of deceptive sales practices by NFA Members, and that is precisely where we have focused our rulemaking and rule enforcement efforts. The entire futures industry can be justly proud that its sales practice regulations are second to none in their comprehensiveness and effectiveness.

To begin with, there's the CFTC regulations regarding risk disclosures for both futures and options. The futures risk disclosure statement in CFTC Regulation 1.55 describes the risks of futures trading in a one-page statement written in plain language that would scare the spots off a leopard. The options risk disclosure is equally effective and thorough. NFA's "Know Your Customer" rule takes those risk disclosures one step further by requiring that certain customers have to be warned that futures trading is just too risky for them and that they do not belong in these markets. On top of all of that, NFA Compliance Rules not only bar high-pressure sales practices -- they actually require that any standardized telephone solicitation which even mentions the possibility of profit must be accompanied by an equally prominent statement of the risk of loss. Considering all of these rules, together with all of the other anti-fraud provisions of the Commodity Exchange Act, CFTC regulations, exchange rules and NFA rules, I am not aware of any industry selling any product anywhere that has a more pervasive network of customer protection regulations.

Furthermore, those regulations are being aggressively enforced. Comparing NFA's first three years to the last three years, sales practice complaints increased from 12 to 66, expulsions from 12 to 39 and fines from just over $100,000 to over $1,000,000. All of this is in addition to the numerous significant sales practice cases which the Commission has brought.

Notwithstanding all of the rules that already exist and the effective enforcement of those rules, NFA feels that if even one customer is the victim of a deceptive or high-pressure sales pitch from an NFA Member, that is one victim too many, and we would welcome any legislation which would help combat that tiny percentage of our membership which engages in this type of conduct. Unfortunately, we have serious reservations whether the proposed legislation would have that effect.

No rule devised by man can prevent someone from committing fraud if that's what they are intent upon doing. The proposed rule is no different. It can be broken just as the existing rules can be, and I doubt that detecting violations of such a rule would be any easier than the rules that are currently in place.

While the proposed rule may not affect that fringe element of our business which uses deceptive sales practices, it could well be unduly burdensome to the overwhelming majority of our Members who are honest, legitimate businessmen. Identifying just which "first-time" customers were solicited by phone could pose substantial problems in the real world. In addition, there may be sophisticated, institutional customers whose trading may not be exclusively hedge trades for whom this "protection" would be both unnecessary and potentially harmful.

If there was a way to narrow the focus of this concept to pinpoint the relative handful of unscrupulous firms in the industry, NFA could support the proposal. In its present form, however, we have reservations as to whether its doubtful benefits outweigh its substantial burdens.

V. PUBLIC REPRESENTATION ON THE BOARD

With respect to public representation on our Board of Directors, NFA has always recognized the invaluable perspective which public representatives bring to the regulatory issues NFA deals with. From our very inception, our Articles of Incorporation have always provided for public representatives on our Board. Three of the 42 persons on our Board are elected as public representatives. Their varied backgrounds bring a wealth of industry, legislative and academic perspectives to our Board.

But those public representatives are not the only outside voices on NFA's Board of Directors. Commercial firms and commercial banking institutions are not regulated by NFA and yet we have always recognized that these important users of the futures markets could bring valuable insights to our Board. Therefore, from our very inception, our Articles of Incorporation have provided five additional seats on our Board for those two categories, with two seats allotted to commercial banks and three seats provided for commercial firms. In all, eight of the 42 seats on our Board, or roughly 19%, are set aside for persons who are not registered in any capacity under the Act and who are not regulated by NFA.

The language of the proposed amendment to Section 17(b) of the Act would require that at least 20% of our Board consist of "outside members." I assume that the Committee's intent is that the phrase "outside members" would include both public representatives and commercial bank and commercial firm representatives since they are all "outside" NFA's regulatory jurisdiction. If my assumption is correct, NFA is already in substantial compliance with the proposal.

VI. STANDARDS FOR MEMBERSHIP ON NFA'S BOARD OF DIRECTORS AND DISCIPLINARY COMMITTEES

The issue of qualification standards to serve on NFA's Board of Directors and disciplinary committees is one which our Executive Committee is currently considering. We have historically been blessed at NFA with a Board of Directors and disciplinary committees which have been drawn from among the most respected leaders in the industry. We certainly support any proposal which will ensure that that tradition continues.

It may well be appropriate to disqualify from Board or committee membership persons who have been found to have committed "a major rule violation." We would caution the Committee, however, that in determining what constitutes a "major rule violation," the focus must be not on the rule but on the violation. All NFA compliance rules are designed in one way or another to protect the public. A violation of any of those rules could so undermine one's confidence in a person's judgment that he should be disqualified from Board membership. At the same time, a violation of any of those rules may be technical in nature. The best way to determine a "major rule violation" is to focus not on the rule that was violated but on the sanction that was imposed. If that reflects the Committee's intent, we certainly support the proposed amendment.

VII. ETHICS TRAINING

NFA also agrees with the Committee on the importance of ensuring that registrants receive adequate training concerning their ethical responsibilities to their customers. To that end, NFA has already made significant changes to the content and format of the National Commodities Futures Examination. With very limited exceptions, NFA requires all applicants for AP registration to take and pass this proficiency examination. The content of the exam has been changed over the last few years to put greater emphasis on testing the applicant's knowledge of regulatory requirements as well as market knowledge. The questions on regulatory requirements center on those rules concerning fair dealings with customers.

NFA's Board took this process one step further in 1987 when it approved a fundamental change in the way that the exam is graded. For grading purposes, the exam is divided into two parts -- market knowledge and knowledge of regulatory requirements. The two sections are graded separately and an applicant must pass both sections of the exam in order to become registered.

The changes outlined above have already improved the industry's attention to ethics training, but we fully support any proposed amendments which will focus even greater attention on this critical area. However, given the current focus of the proficiency exam on ethical issues, we question the efficiency of requiring newly registered APs to take an ethics refresher course within six months of passing the exam and becoming registered.

VIII. REAUTHORIZATION PERIOD

NFA also strongly supports the proposal to make the CFTC a permanent agency. This proposal would ensure continuing congressional oversight of the CFTC but would eliminate current uncertainties about the agency's existence and could serve to increase the Commission's resources to effectively regulate the futures markets. In our view, such a proposal is both welcome and long overdue.

DJR:cm(MISC)

APPENDIX TO

TESTIMONY OF ROBERT K. WILMOUTH
PRESIDENT
NATIONAL FUTURES ASSOCIATION

BEFORE THE HOUSE AGRICULTURE SUBCOMMITTEE
ON CONSERVATION, CREDIT, AND RURAL DEVELOPMENT
RE: H.R. 2869

NATIONAL FUTURES ASSOCIATION
A CONTINUING COMMITMENT TO EXCELLENCE: A REPORT AS OF DECEMBER 31, 1988

EXECUTIVE SUMMARY

I. INTRODUCTION

The very concept of self-regulation is now under a cloud of suspicion. Recent press reports concerning investigations of an unspecified number of floor brokers and floor traders have caused some to question whether self-regulation can be trusted, even with diligent oversight by the Commodity Futures Trading Commission. The ultimate question is whether industry professionals have demonstrated the ability and the willingness to protect the public by policing themselves. To answer this question, Congress needs not speculation or rumor but cold, hard facts. This report provides those facts and presents overwhelming evidence that *self*-regulation is *tough* regulation.

The list of responsibilities which Congress laid out for NFA was both clear and ambitious. NFA was never intended to duplicate the efforts of either the Commission or the exchanges, and it has not done so. NFA's regulatory efforts have focused not on trading floor activity but on all other aspects of its Members' dealings with the public. NFA's primary responsibilities include:

- developing rules to ensure that the highest ethical standards are observed by Members in their business and sales practices;
- conducting investigations and audits to detect violations of those rules;
- taking disciplinary action to punish and deter such violations;
- preventing unethical firms from entering or remaining in the industry by performing the registration function on behalf of the Commission;
- preventing fraud by educating the public concerning the risks and opportunities in the futures markets so that customers can make fully informed investment decisions; and
- providing customers with an arbitration forum which offers a fair, prompt and inexpensive means of resolving futures-related disputes.

Those are the jobs which Congress and the industry have assigned to NFA. In each of these areas and the others discussed in this report, NFA's performance shows that at NFA self-regulation not only works but excels.

II. COMPLIANCE RELATED MATTERS

The formula for effective self-regulation at NFA is no real mystery. It involves three basic components — strong rules, thorough investigations and tough enforcement actions. In the past three years, NFA's continuing commitment to excellence has been evident in all three of these critical areas.

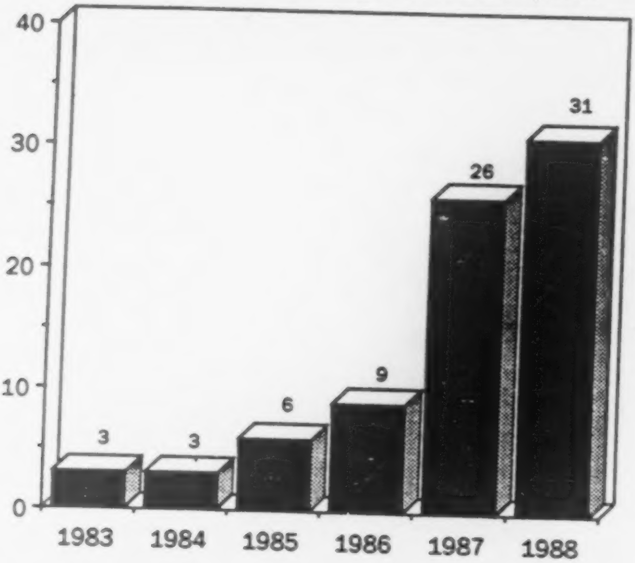
Since the date of the last full report that Congress received concerning NFA's activities, September 30, 1985, NFA has adopted or implemented numerous new rules dealing with subjects ranging from telemarketing fraud and deceptive advertising to foreign futures and options:

- Compliance Rule 2-29 bars the use of high-pressure sales practices and sets strict content requirements for all telephone solicitations and advertising materials used by NFA Members;
- Compliance Rule 2-30 sets an industrywide Know Your Customer standard and provides that certain customers must be told that futures trading is simply too risky for them in light of their overall financial condition;
- *NFA's Guideline for the Disclosure by FCMs and IBs of Costs Associated with Futures Transactions* ensures that customers of NFA Members are provided with sufficient information about the costs of futures trading to make an informed decision and to compare the fees charged by different firms;
- NFA's guideline concerning "up front" fees charged by CPOs and CTAs requires that such fees be fully disclosed before the customer invests;
- NFA Compliance Rules and Bylaws were amended to extend NFA's customer protection rules to the activities of NFA Members regarding foreign futures and option transactions; and
- NFA's proficiency testing program was improved with increased emphasis on the industry's ethical and regulatory requirements.

The toughest rules in the world, however, will not help protect customers if violations can routinely go undetected. NFA has added to its standard auditing and investigative procedures a new program using covert investigative techniques to learn firsthand what NFA Members are telling prospective customers over the telephone. Using phone numbers with out-of-state area codes and corresponding mailing addresses, NFA staff members have posed as prospective customers to receive telephone solicitations directly from Members. This highly successful program has been expanded by enlisting the assistance of state securities regulators from around the country and has produced a number of successful disciplinary actions.

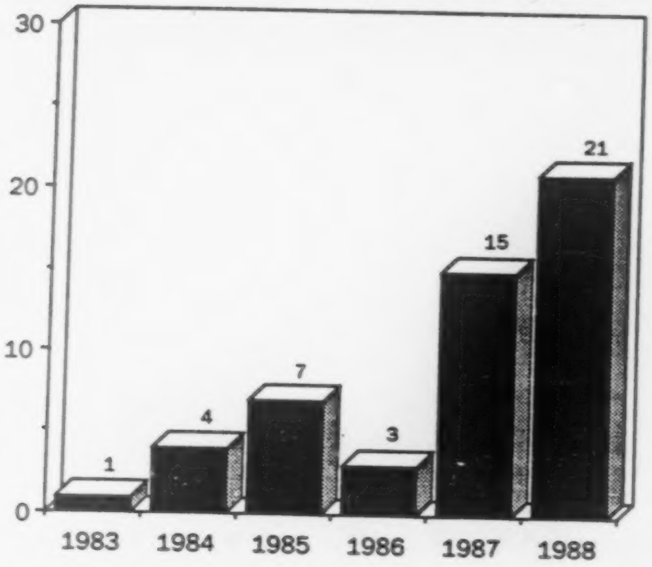
The adoption of these new rules and investigative programs has led to dramatic increases in all aspects of NFA's enforcement program. The overall number of disciplinary proceedings initiated by NFA's Regional Business Conduct Committees ballooned from 51 in NFA's first three years to 119 in the last three years. Moreover, the lion's share of that increase comes from cases involving telemarketing fraud or other forms of deception of customers.

SALES PRACTICE COMPLAINTS ISSUED BY BCCs
From January 1, 1983 through December 31, 1988



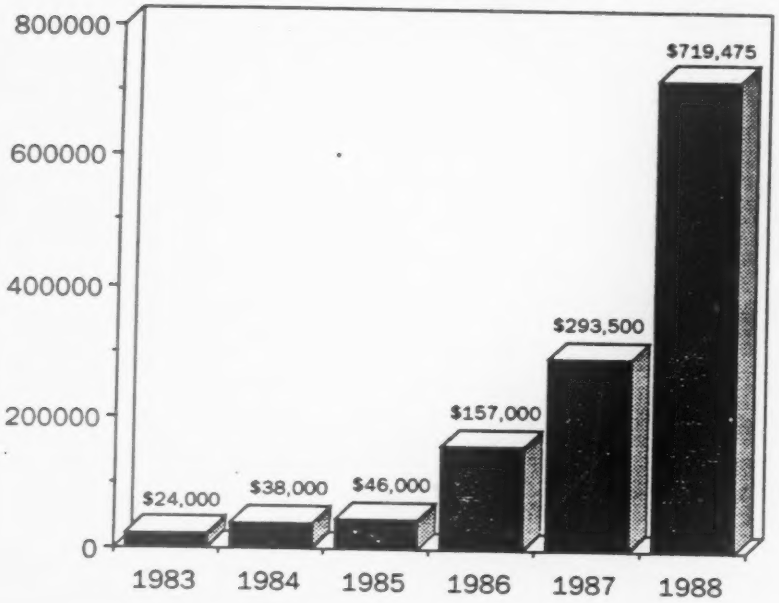
The bottom line, of course, is not how many Complaints were issued but what types of sanctions were imposed. Once again, the numbers tell the story. The most severe sanction which NFA can impose is expulsion from membership since that effectively bars the firm or individual from the industry. In its first three years, NFA expelled 12 Members through disciplinary proceedings compared with 15 expulsions in 1987 alone and 21 more in 1988.

EXPULSIONS ORDERED BY BCCs
From January 1, 1983 through December 31, 1988



Business Conduct Committees can also impose fines and have done so in record numbers over the last three years. In NFA's first three years combined, Business Conduct Committees imposed a total of $108,000 in fines, a figure which was surpassed in each of the last three years. Fines in 1986 totalled $157,000, almost doubled in 1987 to over $293,000 and more than doubled in 1988 to over $719,000.

FINES LEVIED BY BCCs
From January 1, 1983 through December 31, 1988



Strong rules, thorough investigations and tough enforcement actions — all three have contributed to a successsful enforcement program at NFA.

III. REGISTRATION AND MEMBERSHIP

One of the best ways to protect the public from unscrupulous firms and individuals is to keep those people out of the industry in the first place. That is the job that NFA has been handling since October 1, 1985, when it assumed responsibility for registration denial and revocation proceedings for all categories of registrants except floor brokers, leverage transaction merchants and their associated persons. Just as with enforcement matters, effectively screening out unethical individuals and firms in the registration process requires three basic components: specific legal criteria to determine registration fitness, a reliable screening process to identify the applicants who do not meet those criteria and effective proceedings to bar those persons from the industry.

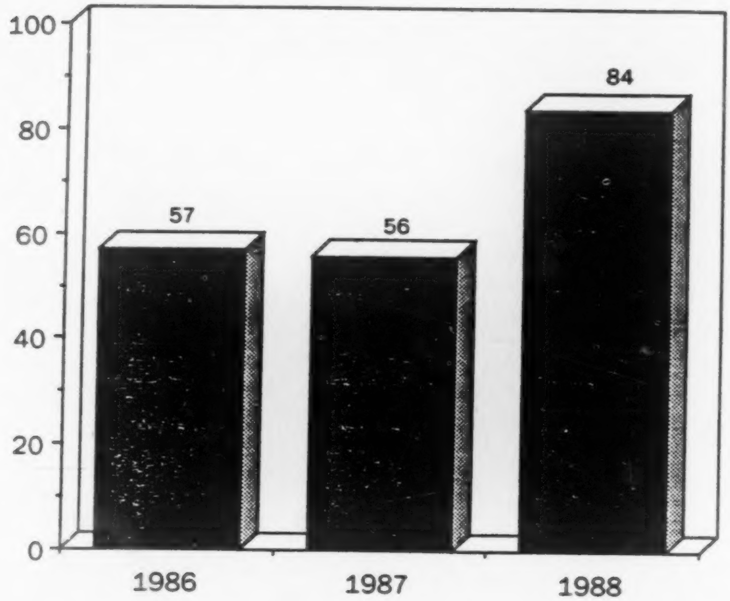
The legal criteria used by NFA are those supplied by Congress. In 1982, Congress amended the Act to establish a two-tier system of disqualifications from registration. The more egregious disqualifications, such as prior revocations and certain types of felony convictions, are set forth in Section 8a(2) of the Act while Section 8a(3) sets forth less serious disqualifications, such as certain misdemeanor and felony convictions and actions by self-regulatory bodies. Most of these statutory disqualifications provide very specific guidance. The needed flexibility comes from Section 8a(3)(M) of the Act which provides that registration may be denied or revoked for "other good cause." Over the last three years, NFA's Membership Committee has applied the "other good cause" standard and the other statutory disqualifications on a case-by-case basis and has developed a body of case law which has tightened and improved the registration screening function.

Though the legal criteria set forth in the Act set parameters for judging registration fitness, it is NFA's application review process which applies those criteria to the real world. All registration applications processed by NFA are subject to close scrutiny to determine whether the standards set by Congress have been met. Each application contains a series of questions which have been specifically designed to track the statutory disqualifications set out in the Act. Any "yes" answer to those questions will automatically bar the applicant from receiving a temporary license and will trigger an intensive review and possible denial proceeding by NFA. Of course, with regard to critical information such as an applicant's disciplinary history, NFA does not rely solely on the applicant's answers. NFA seeks independent corroboration of the disciplinary history information on each application by conducting an FBI fingerprint check and a review of CFTC and SEC disciplinary records. In addition, any material derogatory information received through NFA audits or investigations, from discharge notices from past employers or from any other source will be reviewed and, if appropriate, a denial proceeding will be initiated. Less critical information, such as employment and educational history data, must be verified by the applicant's sponsor. The sponsor must, at the risk of its own registration, sign a sworn statement that it has done so. NFA has recently taken steps to further supplement the sponsor's verification with its own spot-check of educational and employment information on randomly selected applications.

The ultimate proof of the thoroughness of the screening process is the number of denial or revocation proceedings which have been initiated. In the last three years, NFA has taken action in almost 200 cases to deny or revoke registrations. Furthermore, the 84 cases brought in 1988 represent a 50% increase over the previous year's total.

Not surprisingly, a disproportionate share of these cases involve a relative handful of sponsoring firms. In fact, just six sponsoring firms, .017% of NFA's membership, have been involved in 23% of the registration actions NFA has initiated. Five of those six firms have already been the subject of NFA disciplinary actions, three are now out of business and barred from the industry and two have been subject to substantial fines.

TOTAL NUMBER OF FITNESS ACTIONS INITIATED BY NFA
From January 1, 1986 through December 31, 1988



In processing the thousands of applications which come in each year, it is just as important to process promptly the 99% of the applicants who are qualified as it is to screen out the 1% who are not. NFA has scored well on both counts. The processing time required to grant temporary licenses has steadily been reduced from an average of 8.7 days in 1986 to an average of 4.4 days in 1988. Furthermore, this 50% reduction in processing time was achieved at the same time that there was a 25% reduction in the Registration Department's staff, largely as the result of refinements that have been made to NFA's computer programs and capabilities.

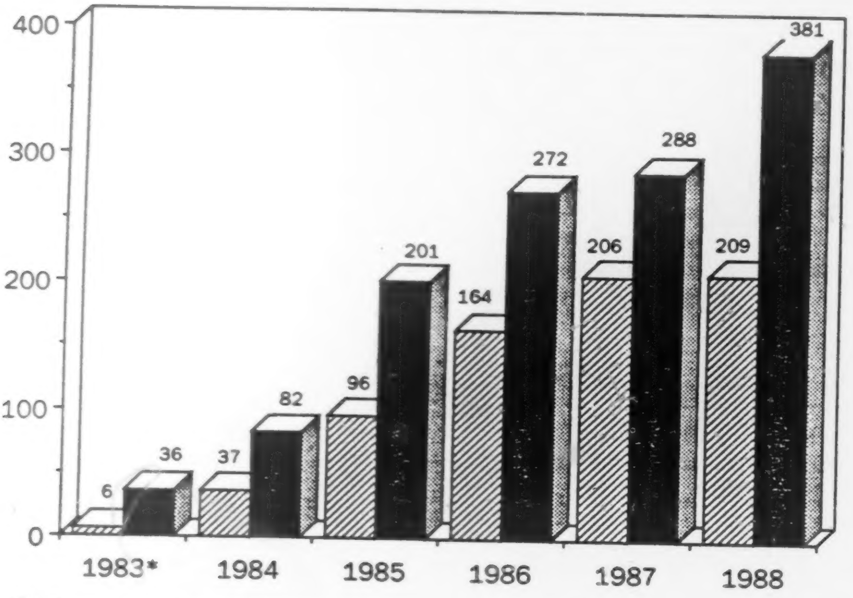
IV. ARBITRATION

Congress has always recognized the value of arbitration as a means of resolving customer disputes in the futures industry. In fact, in 1974, when Congress first passed the enabling legislation which led to the creation of NFA, it specifically required any registered futures association to provide an arbitration program or an equivalent program as a condition of its registration.

In its first three years, NFA built from scratch an arbitration program which provides customers in the futures industry with precisely what Congress intended — an expeditious forum for the fair resolution of disputes. Rules were developed, procedures implemented and a nationwide pool of volunteer arbitrators was assembled.

In the last three years, NFA has built on that foundation to continue to provide a high quality and inexpensive alternative to litigation. The dramatic growth of NFA's arbitration program is the clearest sign of its quality and its acceptance by the investing public it is designed to serve. In its first three years, the program received approximately 300 Demands for arbitration from customers. In the last three years, that number more than tripled with almost 1,000 Demands being filed. In fact, 1988 alone saw a 30% increase in filings over the previous year with almost 400 Demands filed. With the increase of cases filed there has been a corresponding increase in cases which have been concluded.

DEMANDS AND COMPLETED CASES
By Operating Year



▨ Cases closed through Settlement or Hearing

■ Demands

* Covers the Period 4/1/83 — 9/30/83

With such exponential growth, of course, comes a great challenge — the challenge to maintain all of the advantages arbitration is intended to provide. NFA has met that challenge. In its last three years, the arbitration program at NFA has continued:

- to provide an inexpensive alternative to litigation. Despite the growth of the program, customer filing costs have remained modest.
- to provide a prompt resolution of disputes. NFA's arbitration cases are resolved in a fraction of the time consumed in litigation.

- to provide a convenient forum for customers. NFA has maintained a pool of volunteer arbitrators in 48 states and continues to routinely provide customers with hearings in locations convenient to the customers.
- to provide an informal program. NFA's rules and procedures are designed to be simple enough that any customer can easily represent himself if he chooses to without becoming lost in a maze of legalistic maneuvering.

Most important of all, NFA has continued to provide a fair forum for the resolution of disputes. The statistics on recovery of funds by customers through NFA's arbitration program emphatically rebut any contention that customers do not get a fair and impartial hearing.

NFA has also responded to the challenge of growth by refining its rules, simplifying its procedures, expanding its jurisdiction and computerizing its docketing system.

V. CONSUMER EDUCATION AND ASSISTANCE

NFA recognizes that the best protection against investment fraud is a well informed consumer and has, therefore, always made consumer education one of its most important priorities. Throughout the last three years, NFA has continued to spread its message of consumer awareness through every available medium — by radio, television, film, seminars, printed materials and direct contact with members of the public.

That direct contact with the public occurs hundreds of times each week with the use of NFA's toll-free number. The highly trained staff in NFA's Information Center handled over 125,000 calls in 1988 alone, many from customers with questions about individuals or firms with whom they were considering doing business or with requests for NFA educational brochures. But the telephone is not the only way NFA reaches out and touches the public. NFA has continued to publish and distribute a wide variety of brochures concerning the futures industry and the steps which customers can take to ensure that their investment decisions are based on full and accurate information. NFA representatives have also continued to appear frequently on various radio and television programs focusing on customer protection and the futures industry. In 1989, NFA took this practice one step further and produced its own 14-minute film entitled *For the Investor's Protection*. The film provides basic information on how the futures industry functions and describes the services which NFA offers to the public. In all of these educational activities, NFA works closely with other groups and agencies such as the American Council on Consumer Interests, the National Association of Consumer Agency Administrators, the American Association of Retired Persons and the U.S. Office of Consumer Affairs.

VI. OTHER CUSTOMER PROTECTION SERVICES

Though the customer services and programs discussed above are NFA's primary responsibilities, they are certainly not its only ones. Repeatedly over the past three years, NFA has been called upon to take on additional responsibilities, and each time NFA has answered the call. These additional responsibilities and projects are detailed in this report and include the following activities:

- NFA has saved customers who were involved in a class action suit against a firm which had previously been expelled from NFA tens of thousands of dollars by serving as a court-appointed administrator of a $5.3 million settlement fund. NFA was requested to administer the fund by the court and by the parties and agreed to do so since by recovering only its out-of-pocket expenses NFA could preserve more of the settlement fund for the customers involved;

- At the Commission's request, NFA performed a comprehensive study of the issue of FCM insolvencies, the protective measures already in place to guard against them and the feasibility of various additional protective and responsive mechanisms;

- NFA has continuously worked closely with federal and state law enforcement and regulatory officials to assist in any way possible with any futures-related investigations. For example, NFA meets on a quarterly basis with representatives of the FBI and the Postal Inspector's Office to review NFA disciplinary actions involving potential criminal violations. NFA's cooperation has resulted in a number of successful investigations and prosecutions;

- NFA has been an active participant in the Justice Department's Securities and Commodities Fraud Working Group. This group consists of federal and state prosecutors and regulators along with self-regulators from the securities and futures industries. The group meets quarterly to discuss issues involving techniques and regulatory coordination; and

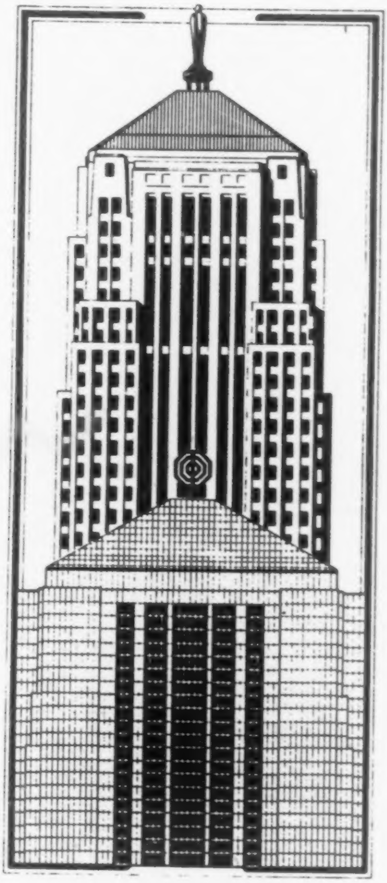
- At the request of Congress, NFA assisted the Commission in conducting a survey regarding the leverage industry and the possible consequences of lifting the current moratoria on firms entering that business.

NFA performed each of these tasks without in any way diminishing its other ongoing customer protection programs. Furthermore, while increasing the scope and effectiveness of its regulatory activities over the last three years, NFA has actually reduced the cost paid for NFA services by the trading public which it serves. The NFA assessment fees for both futures and options trades have steadily decreased from 33¢ for futures and 20¢ for options when NFA began operations to a projected level of 20¢ for futures and 12¢ for options effective July 1, 1989.

VII. CONCLUSION

A periodic review by Congress of the effectiveness of the concept of self-regulation in the futures industry is both necessary and welcome. Ultimately, such a review can only benefit the industry, its regulators and, most importantly, the public we are all trying to serve. To be effective, that inquiry must focus on documented facts. NFA strongly believes that the documented facts concerning its record of accomplishment throughout its history have vindicated the confidence that Congress, the Commission and the industry have placed in it.

Supplemental Submission Before the Conservation, Credit and Rural Development Subcommittee of the House Agriculture Committee



Chicago Board of Trade

July 20, 1989

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EXECUTIVE SUMMARY

The Board of Trade of the City of Chicago is the world's oldest and largest futures exchange, not only because CBOT markets are the most liquid, cost-efficient markets in the world, but also because of the Exchange's committment to the highest degree of market integrity. Professional market user confidence in both the integrity and efficiency of CBOT markets is best demonstrated by the record volume which the Exchange has experienced each year for the last decade.

The Exchange does not now condone, and never has condoned, trading abuses of any kind. Founded on the concept of self-regulation, the Exchange has consistently policed and disciplined its own members. When floor trading abuses are detected and proven, the Exchange has always sanctioned violators appropriately, including the imposition of suspensions, fines and expulsions. The Exchange's commitment to preserving the utmost market integrity is undiminished today.

The cornerstone of market integrity is membership integrity. The Board of Trade has always maintained the highest standards of member qualification. As United States Attorney Anton Valukus recently asserted, "the best experts in the world concerning trading practices are the members of the Board of Trade."

Additionally, the Department of Investigations & Audit's ("OIA") use of the Computerized Trade Reconstruction system ("CTR") is a vital means of detecting rule violations thereby insuring market integrity. CTR is universally acknowledged to be the best audit trail in any of the world's financial marketplaces. Similarly, CTR-PLUS, the Exchange's surveillance system, is an unsurpassed system for the detection of potential market abuses. Indeed, the CTR-PLUS system highlighted as a potential abuse the trading activity of an apparent FBI agent trading as a member at the exchange, presumably pursuant to a federal investigation. As U.S. Attorney Valukus has acknowledged, the Board of Trade has "... the resources to identify trading practices in which fraud has occurred."

Regardless of this unparalleled record of success, the Exchange has consistently recognized that the process of improving its markets and surveillance systems is one of constant evolution. On an ongoing basis, the Exchange examines its market mechanisms and surveillance techniques to insure that it remains the world leader in this regard. This self examination process has intensified recently in the wake of the sensationalized press reports of FBI and United States Attorney investigations into alleged trading floor abuses at the Chicago Mercantile Exchange and the Board of Trade.

While no confirmation of any trading abuses has yet been offered, no indictments issued, and no convictions obtained, the Exchange has nevertheless recognized that continued public confidence in the marketplace requires an intensive review of market mechanisms as well as the surveillance and disciplinary processes. For the past several months, special exchange committees have engaged in detailed reviews and examinations of the Exchange's market structure and enforcement mechanisms. Those deliberations have resulted in reports to the Board of Directors. The Board, in turn, has approved (not merely proposed) numerous revisions in our market mechanisms and enforcement procedures. Those market enhancements are summarized below.

On July 12, 1989, Representatives English, Coleman and Penny introduced H.R. 2869, the Commodity Futures Improvements Act of 1989. The proposed legislation would make sweeping changes to several vital provisions of the Commodity Exchange Act ("CEA"). The Exchange supports the stated purposes of the bill to restrict potential abusive practices and reinforce development of exchange audit trails. However, we are greatly concerned that in critical areas of the bill the precise methodology proposed to achieve those common objectives may, at a minimum, render our domestic futures industry uncompetitive with ever increasing foreign markets and potentially destroy market liquidity. The proposals regarding dual trading by floor brokers and the requisite audit trail requirements are particularly crucial and require a modified approach.

Broker Trading (Dual Trading)

Permitting floor brokers in the futures industry to trade for their own account while also executing customer orders recently has come into question. Despite the fact that there have been no indications that any federal investigation is concerned with any aspect of broker trading, and despite the fact that the CTR-PLUS system is specifically programmed to detect (inter alia) any broker trading ahead of a customer's order, a few have questioned whether this practice is in the best interest of the marketplace.

First, broker trading is not unique to futures markets. Trading for one's own account while handling customer orders is a common practice in all financial markets: specialists and securities firms universally trade for their own account while executing customer orders.

Second, Congress, the CFTC and the futures industry have studied broker trading many times in the past decades. In each instance, the results overwhelmingly indicate that the ability of floor brokers to provide additional liquidity to the market by trading for their personal accounts is a valuable and necessary part of the marketplace. Preliminary Exchange data indicates that broker trading provides from 25-80% of futures market liquidity at the CBOT. The Exchange strongly believes that any potential abuses of dual trading can be and are detected by current surveillance systems. Therefore, the Exchange feels that the elimination of broker trading would seriously impair market liquidity while serving no useful market purpose.

However, the Exchange recognizes that concerns exist. Thus, the Board has retained the services of Dr. Sanford J. Grossman, the John L. Weinberg Professor of Economics at Princeton University, to make a comprehensive empirical study of broker trading in today's futures markets. This study, along with those conducted in the past, as well as studies conducted by the Exchange staff, and now being conducted by the Commodity Futures Trading Commission ("CFTC" or the "Commission") will form the basis of further evaluation of the value of broker trading to the nation's futures markets.

The Board of Trade strongly urges this Committee to evaluate these studies in their entirety, as well as additional studies which may be submitted to the Committee, before making any final decision on this vital issue. The liquidity of the world's most efficient futures markets is at stake. The continued preeminence of United States futures markets deserves careful, considered study before any final recommendations for action.

The specific provisions of H.R. 2869 regarding dual trading are draconian and potentially devastating. Banning dual trading in contracts trading more than seven thousand (7,000) contracts per day is arbitrary and without any sound economic basis. Had such a prohibition been in effect from 1984-1988, the nation's grain markets would have suffered even more severely than they did; had floor brokers not been able to supplement their incomes during that depressed period by also trading for their own account, there would have been all too few, if any, experienced, capable brokers to execute the flood of orders which came to the markets in the summer of 1988.

The audit trail exemption to the ban contained in proposed Section 4j(1)(D) requires perfection which is humanly impossible to achieve. Detecting "... any and all instances of trading violations ... attributable to dual trading ..." and being "... fully verifiable" are absolute standards unattainable in the real world.

The proposals seem to ignore the fact that the United States futures markets presently have the best audit trail and computer surveillance systems in any marketplace, foreign or domestic. To place these unattainable standards upon an already excellent system is laudable in intent but questionable in reality. This is especially true given that the Chicago Board of Trade and the Chicago Mercantile Exchange have agreed to combine their existing computerized audit trail and surveillance systems into a single system capable of being used by the entire industry. Since both systems presently capture 100% of all trades and audit 100% of all trades for market surveillance purposes, the combined systems will achieve a level of review unmatched anywhere.

The Board of Trade is also investigating further technological means to improve the accuracy of the existing audit trail. However, our research indicates that despite such efforts, there are limitations to the adaptability of current technology to our markets without risking destruction of market liquidity. In this regard, the proposal of Section 4g(2)(B)(ii)(b) to state verifiable execution times within thirty (30) seconds, and to accomplish this within three (3) years, appears totally unrealistic and unobtainable. Moreover, this unrealistic, unobtainable standard appears unnecessary, particularly in view of the nature and extent of recent audit trail enhancements approved by our Board of Directors.

The Exchange urges this Committee to consider modifying the provisions of the bill as follows: (1) ban dual trading in those contract market option months where the exchange's audit trail and surveillance systems are insufficient to detect potential abuses that may be associated with dual trading; (2) provide certain exemptions from the prohibition (such as to those brokers who are predominantly spread brokers); (3) codify the existing exchange prohibition of trading ahead of (or "frontrunning") a customer's order; and (4) require that each exchange's audit trail be verifiable to the nearest minute. Adopting these modifications achieves the Committee's objective of insuring the highest degree of market integrity without sacrificing the market liquidity needed to compete in today's world markets.

Exchange Surveillance Systems Market Enhancements (Audit Trails)

As a result of the recent extensive reviews by select Committees, the Exchange has instituted numerous enhancements to the CTR and CTR-PLUS systems. The following enhancements and improvements have been approved:

1) The CTR-PLUS surveillance program has been expanded to analyze every trade made on the Exchange, rather than statistically selected samples.

2) A one million dollar fund for the further improvement of the CTR and CTR-Plus systems has been authorized.

3) Trade time recordation brackets have been reduced from thirty (30) minutes to fifteen (15) minutes.

4) New five (5) minute time brackets have been approved for the opening and closing periods of trade when trading generally is heaviest.

5) The Exchange has enhanced trading card recordation requirements to now require that all trade cards must be accounted for; all trading cards must be collected and time-stamped hourly; and all trades must be submitted to the Clearing House within one hour of collection.

6) CTR-PLUS has been improved further by providing expanded surveillance tests, an expanded relational data base, and increased storage capacity.

7) The Exchange has required that all trading-floor-time stamp clocks be synchronized and accurate to within ten second intervals.

8) Additionally, five new computer programmers have been hired to support an extensive member/staff review and revision process of all surveillance systems.

Office of Investigation and Audits Enhancements

The Office of Investigations and Audits ("OIA"), the second largest department at the Exchange, has always maintained the highest level of professionalism and excellence. The high degree of professionalism exhibited by OIA has prompted U.S. Attorney Valukus to remark "I have a great deal of confidence in the staff of the Board of Trade." To further strengthen OIA, the Exchange has recommended further enhancements. These include:

9) OIA professional personnel will be expanded by thirty percent (30%) over 1988 levels;

10) The attorney staff exclusively supporting OIA efforts has been increased threefold.

11) Special training programs in investigative techniques conducted by professional consultants have been approved and instituted for OIA staff.

12) An increased presence of OIA investigators on the trading floor has been approved.

Board of Directors Policies

The Exchange has reexamined the powers, authorities and structure of its Board of Directors. The Exchange Board is currently a diversified body consisting of representatives from all aspects of the industry as well as public directors. The Rules of the Exchange and the diverse structure of the membership insure that such broad representation will continue to exist. To enhance the function of the Directors, the Board has approved the following measures:

13) The Board has approved and submitted for membership approval a rule amendment increasing the fining authority of the Board of Directors by more than three hundred percent (300%) from seventy-five thousand dollars ($75,000) per violation to two hundred fifty thousand dollars ($250,000) per violation.
14) The Board of Directors has formally reaffirmed its long-standing policy of excluding members with a history of significant trade practice sanctions from being on the Board of Directors and major exchange disciplinary committees.

Floor Practices

The Exchange has reviewed intensively existing policies, rules, regulations and practices governing floor trading. The Exchange believes that its rules and policies are highly refined to preserve both the utmost integrity and market efficiency. Nevertheless, the following enhancements have been made:

15) Broker associations generally do not exist at the Board of Trade. Nevertheless, to prevent abusive associations from evolving, the Exchange has adopted a rule requiring that any association of floor brokers must register with the Exchange in order to enhance the Exchange's surveillance of their trading activities.

16) The Exchange has approved and submitted to the CFTC for its approval a rule establishing a modified closing call period at the conclusion of trading to better facilitate orderly execution of closing orders and increase the efficiency of price discovery during closing market periods. This rule includes separate identification of this modified closing call period for CTR-PLUS surveillance purposes.

17) The Exchange has prohibited floor clerks from maintaining trading accounts.

The Exchange also has done extensive work in two other areas which will enhance the Exchange's audit trail and, therefore, its surveillance capability. For many months, the Exchange has been developing an electronic order-entry system ("EOS") which will speed public orders directly to the pit via computerized entry; the resulting order record will be accurate to the second and will greatly enhance surveillance as well as better serve public customers.

Additionally, the Exchange has under review the development of a hand-held trade entry device for use by members on the floor to record electronically all their trades and instantly transmit the trades for clearing. Although the technology for such a device is not presently available, the Exchange has committed significant resources to the development of a hand-held trade terminal which will accurately record trade execution to the second.

The Board of Trade believes these improvements and others still under study will insure that its markets remain the world's most efficient, liquid and economical while simultaneously preserving the highest degree of integrity and professional participation. This is a goal which we believe that all of us -- futures exchanges, the CFTC, Congress and market participants -- share equally. Other exchanges (which have different markets, trade other products, have separate memberships and, in many cases, different market users) may have distinct needs with respect to enhancements of their existing systems. We strongly urge this Subcommittee to consider these differences in its consideration of any legislation.

We believe that if the Subcommittee does so, it will conclude that any regulation of the marketplace is best accomplished in a "management by objective" fashion. For example, when Congress and the CFTC mandated improvements to the audit trail in 1986, that mandate provided that each exchange should meet a common goal by whatever means is best suited to its markets. Thus, the Board of Trade and Chicago Mercantile Exchange responded by developing CTR. So too, in any new requirements for market enhancements and improvements, Congress and the CFTC should similarly establish broad objectives which the self regulatory organizations are obligated to meet, but in the manner which they choose to best serve their particular marketplace.

The end result of such a management-by-objective approach will undoubtedly be the further improvement of our existing efficient, liquid and honest futures markets. The danger of failing to achieve this goal is that our current markets could easily be exported to foreign nations who are eagerly establishing new futures markets hoping to capture what is now a uniquely American industry.

THE EXCHANGE

The Board of Trade of the City of Chicago is the world's oldest and largest futures exchange. Founded in 1848, the Exchange currently is designated by the Commodity Futures Trading Commission ("CFTC") as a contract market for fifty eight (58) futures and futures options products, twenty six (26) of which are actively trading; these include grains, financial futures and precious metals. Four of the world's top ten contracts (by 1988 volume) are traded at the Board of Trade: United States Treasury Bond Futures; Options on U.S. Treasury Bond Futures; Soybean Futures; and Corn Futures. In 1988, the Exchange traded 143 million contracts, nearly twice that of the next largest domestic futures exchange and more than the next four domestic exchanges combined.

The Exchange strongly believes that the prevention of potential market abuses begins with the integrity of the membership itself. Innumerable member, staff and outside professional investigation hours are expended on each application to insure that the utmost member integrity is attained. In 1988, eight hundred twenty (820) applications for membership were processed by the Exchange. Members must trade (i.e. contract with) other members in the trading pits; the members therefore demand that admission to membership be a determination of individual integrity which ensures fair, honest and equitable dealing among members.

The Exchange membership consists of 1402 Full Members and an approximately equal number of Associate membership and membership interest holders. The membership is a diverse mix of individual ("local") traders, brokers, and member firms including futures commission merchants ("FCMs"), commercial firms, investment banks and other professional market participants.

All members are required by Rule to be "... of good character, reputation, financial responsibility and credit ..." as determined in the first instance by the Membership Committee and approved by the Board of Directors. Those wishing to be licensed floor brokers handling customer orders must also undergo additional investigation through the National Futures Association which includes an FBI fingerprint check.

Applicants are required to submit extensive background information which is subject to independent, professional verification. Applicants must also obtain the sponsorship of two existing members; on some occasions, sponsorship may entail a financial guarantee. The admission process includes at least one personal interview before the Membership Committee. Applicants are then recommended to the Board of Directors for approval or disapproval. Those applicants recommended for disapproval are given the opportunity for a hearing. Disapproved applicants may appeal that action to the CFTC.

This rigorous membership approval process helps assure the fair dealing among members which forms the cornerstone of self-regulation. As commonly recognized, self-regulation does include the ability to promulgate and enforce one's own rules and regulations. Indeed, in 1988, the Exchange made seven hundred fifty-nine (759) rule and regulation revisions. Additionally, in 1988 cases, the Exchange issued charges for trade rule violations in sixty-nine (69) instances resulting in a total of seventeen (17) years of suspensions and $1,475,000 in fines.

But self-regulation means more than rule promulgation and enforcement. It also means that members are not going to tolerate being treated unfairly or dishonestly by their fellow members. Most trading floor abuses involve a trading opportunity withheld from the entire trading arena. Fellow member-traders are not going to condone a lost trading opportunity. Indeed, the majority of Exchange disciplinary actions resulting in significant sanctions began with a complaint from a member regarding another member's conduct.

This is the essence of self-regulation: membership integrity upon admission coupled with the vested interest to preserve that integrity on the trading floor. It is by strict adherence to these principals that the potential for trading abuses is minimized even prior to surveillance, detection, enforcement and sanction. This is a principal reason market users have such confidence in Board of Trade markets. Indeed, in 1988, public market users made only thirty five (35) complaints to the Exchange regarding potential trade practice abuses. Considering the one hundred forty three million (143,000,000) contracts traded, this is a remarkably small percentage of complaints.

Nor is confidence in the integrity of Board of Trade markets, oversight and enforcement limited to professional market users. It is also shared by top law enforcement officials who have experienced through representation of clients at CBOT disciplinary hearings the thoroughness and efficiency of Exchange rule enforcement.

> One of the things we do keep track of is what's taking place at the Board of Trade. We are interested in the proceedings at the Board of Trade. We're interested because, in my estimation based on my own expertise in the area, the best experts in the world concerning trading practices are the members of the Board of Trade. I have a great deal of confidence in the staff of the Board of Trade. They are able to ask the difficult questions; they have the resources to identify trading practices in which fraud has occurred. And frequently, in my experience, when they are holding their hearing, they are able to get to the tough

> questions quickly. And since the individuals that are subject to these proceedings are subject to examination, they ask those questions, get responses and those responses are on the record.
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> * * *
>
> We often in these cases call upon the Board to make an evaluation of members from the Board, individuals from the Board, in helping us to find whether or not there is a fraud involved. That is to say that we rely on their expertise. [Emphasis added.] Remarks of Anton R. Valukas, United States Attorney for the Northern District of Illinois, Kent Commodities Law Institute, Workshop on Enforcement/Criminal Matters, October 21, 1988.

It is this combination of innovative, efficient, liquid markets and a reputation among professional market users for unsurpassed integrity which is largely responsible for the Board of Trade's preeminent position in the world's futures markets. However, that preeminence is fragile. Competition for new markets among domestic exchanges, always fierce, has intensified. But more critically, the challenge of foreign competition for dominance in futures trading is increasing daily.

FOREIGN COMPETITION

The efficiency and liquidity of United States futures markets are the envy of the entire world. Virtually every major nation on earth - Japan, Great Britain, France, Switzerland, Australia and even China - has established futures markets in the image of Chicago's futures markets. These foreign futures markets in many instances are directly subsidized by the national government and are strongly supported by national mandate. There is no secret to futures contract specifications; they can be imitated by photocopy in minutes. It is the experience, expertise and integrity of the floor trading population which establishes Chicago's futures markets as the world leader. But, that market edge is fragile and could be easily upset or destroyed.

The foreign challenge to the U.S. futures industry has increased markedly in recent years. Although activity at U.S. futures exchanges has continued to grow, activity at foreign exchanges has grown much faster. The market share of U.S. exchanges has declined because futures exchanges have proliferated overseas; products offered by foreign exchanges have become more diverse as the benefits of futures markets become better understood. Foreign exchanges now compete directly with American exchanges; there are now several contracts traded on foreign exchanges which are identical to contracts traded domestically.

The statistics are sobering, if not frightening.

In the past four years, the Board of Trade has increased its total volume of contracts traded by 91%. However, during that same period, the Exchange's market share of world-wide futures volume decreased by 3.6 percent (from 37.6% of the world market to 34%). The reason the Exchange lost world market share was that foreign exchange volume grew 226%. (See Appendix 1, Table 1 and Figure 1.)

In 1985, the ten most actively traded futures contracts in the world were all United States products. By 1986, the fifth most actively traded contract was Japanese, a position which it continues to hold today. By 1987, the seventh most actively traded contract was French; today, the French Bond Futures contract has grown to occupy the number six position on the list. (See Appendix 1, Table 3.) In 1985, no foreign futures contracts were among the twenty-five most actively traded. Today, six of the top twenty-five are foreign contracts. (See Appendix 1, Table 4.)

From 1984 to 1988, the number of domestic futues contracts trading grew 35%. But the number of foreign futures contracts trading grew by 84% in that same period. (See Appendix 1, Table 2.) The London International Financial Futures Exchange ("LIFFE") trades a U.S. Treasury Bond Futures contract identical to the Board of Trade's most actively-traded contract. Volume in the LIFFE U.S. T-bond contract has tripled since 1985 to over two million contracts per year.

Statistics prove that market users are willing and able to quickly shift their market activity overseas. For example, U.S. Treasury Bond futures trading was brisk following the October 19, 1987 stock market break. On Tuesday, October 20, prices of the Board of Trade's Bond futures contract increased up to the upper limit allowed for a single day; as required by Exchange rules, trading in T-bond futures was effectively stopped. As a result, less than 35,000 T-bond contracts were traded during daytime trading at the CBOT on October 20 compared to the daily average volume of 286,505 during October, 1987. Instead, market users shifted their activity overseas to the LIFFE when their needs could not be met in the U.S. Volume in the LIFFE T-bond contract exploded to over 47,000 contracts traded on October 20, nearly eight times its average daily volume of 6,200 for the first ten months of 1987. (See Appendix 1, Table 6.) The increase in volume at the LIFFE might have been even greater had market users been more familiar with that exchange and had they not had such a strong preference for the CBOT margin and clearing system.

Despite the well-known integrity and liquidity of the CBOT T-bond contract, participants in the T-bond market sought risk management services elsewhere once trading in the CBOT market stopped. This event demonstrates the ease of shifting futures market activity abroad if necessary. Thus, even the world's most active futures contract is vulnerable to foreign competition.

It is clear that there are now numerous risk management vehicles available to those who need to hedge against price risk and to speculators who are willing to accept that risk. American futures markets compete not only with foreign futures exchanges, but also with alternative risk management vehicles such as forward contracts, swaps, caps, collars and other financial products. These various risk management products are available at the touch of a telephone button; global markets are all easily accessed and are becoming more familiar to market users.

The availability of so many other methods and locations to conduct risk management means that any increase in the costs of using one of these vehicles can result in a huge disadvantage relative to the competition. This high degree of competition means that market users benefit as each provider must keep its costs low, and the quality of customer service must be maintained in order to keep customers. On the other hand, any regulations that increase the cost of using futures markets or reduce the quality of customer service being provided will put the U.S. futures industry at a competitive disadvantage. To choose but one instance, restrictions on broker trading would reduce the efficiency of U.S. futures markets and would lower the quality of service provided to users of these markets. (It should be noted that broker trading commonly is permitted in foreign markets.)

In the face of such intense, dedicated international competition for what were only a few years ago, uniquely American markets, Congress must carefully consider its actions to avoid any action which could cripple domestic futures markets. Even foreign journalists whose home markets stand to benefit from any hasty U.S. legislative reaction have expressly cautioned us not to enact ill-considered legislation.

> America's politicians would therefore be well advised to temper their natural desire to "do something" and refrain from hasty ill-considered regulation of Chicago. That "casino", as it is described by its opponents, is in fact one of America's most successful industries.... Toyko and London, not to mention other financial centres, would clearly love to get a bigger slice and will seize any opportunity to do so. It was, it needs to be remembered, ill-considered American legislation in the 1960's that allowed London to become the centre of the international debt markets, usually known as the Euromarkets. Future Permanent, The Economist, June 11, 1988.

Today, we have the best futures markets in the world, reputed for both their cost efficiency and market integrity. We must carefully preserve that delicate balance in the face of our less regulated foreign competition as we consider any proposals for regulatory change. We must not deceive ourselves into thinking that our foreign competitors will not create a quality product at the lowest price possible. The proof is self-evident; they have done so in countless other industries where the United States was only recently the world leader.

OVERSIGHT & ENFORCEMENT

Competition for market share is not dependent solely on market liquidity and efficiency. Market users value the integrity of the trading process very highly. While strict member admission standards and vested self-interest form the foundation of market integrity, vigorous oversight, surveillance and enforcement are also of paramount importance. As a membership self-regulatory organization, the Board of Trade insures compliance with fair and equitable trade practices principally through the Floor Governors Committee, the Business Conduct Committee, and the Board of Directors.

The duties and powers of the Floor Governors Committee are generally defined by CBOT Rule 543.00 which provides that the Committee shall assure that the practices and conduct of members of the Association, member firms and other persons with trading privileges on the Exchange Floor are in compliance with the Rules and Regulations of the Association. The Committee is authorized to take action against persons and firms including: (1) dismissal of charges and closing the matter; (2) issuance of a warning letter; or (3) issuance of preliminary charges and scheduling of a hearing on the merits. If preliminary charges are issued, the Committee will afford the respondent(s) an opportunity for a formal, evidentiary hearing of record with right to counsel. If, after hearing, the Committee determines rule violations have occurred, the Committee may fine or suspend the respondent or may charge the respondent and refer the matter to the Board for the imposition of sanctions.

Additionally, Regulation 540.09 provides respondents with the opportunity and means to settle preliminary charges. Settlements may be accepted on such terms and conditions as the Committee may deem appropriate.

The duties and powers of the Business Conduct Committee are generally defined in CBOT Rule 542.00 which provides that the Committee is responsible for preventing price manipulation and the cornering of any commodity on the Exchange and for supervising the business conduct of all members, member firms and other persons with trading privileges. In regard to the latter responsibility, two of the duties of the Committee are (1) to enforce the minimum capital rules of the Exchange, as approved by the CFTC; and (2) to enforce Exchange Rules and Regulations pertaining to the handling of customer orders, customer accounts and margins. Other duties include reviewing requests from firms to pre-pay subordinated loans, supervision of firms that are regular for delivery on Board of Trade agricultural contracts, and all general matters of member solvency.

The Committee is authorized to impose specific disciplinary sanctions; to recommend that the Chairman impose restrictions on the operations of a member, member firm or other person with trading privileges; and to impose restrictions on member FCMs that fail to meet the capital requirements of the Exchange. The Committee also is authorized to order any member to cease and desist from past or proposed conduct that it finds, after notice and an opportunity for hearing, to be unfair, unjust or in violation of CBOT Rules and Regulations. The Committee may impose a fine of up to twenty five thousand dollars ($25,000) for each violation. Cease and Desist Orders are final and not appealable. As an alternative to issuing a Cease and Desist Order and/or a fine in disciplinary matters, the Committee may file charges against a member, member firm or other person with trading privileges with the Board of Directors.

Decisions of both the Floor Governors Committee and Business Conduct Committee generally are appealable to the Board of Directors. The Committees may also refer charges to the Board for its disposition where the Committee feels its sanctioning authority is too limited for the severity of the violations found. Thus, the Board functions in the one instance as a pure "appellate" body, and in the other purely as a sentencing forum. In either instance, a general right of appeal from a Board decision to the CFTC is provided by Part Eight of CFTC Regulations.

Member disciplinary committees are uniquely qualified to enforce Exchange rules. The knowledge of trade practices and experience with the business of futures trading possessed by these members cannot be duplicated outside the Exchange. Members of the Floor Governors Committee and Business Conduct Committee typically have ten to twenty years experience in futures trading, most of it at the Exchange. This member expertise is an invaluable and irreplaceable asset in the oversight and enforcement of Exchange rules.

Equally valuable as member expertise is the professional staff support the Committees receive. The Board of Trade continually monitors member and member firm compliance with its rules and regulations, as well as those of the industry, through its Office of Investigations and Audits. As part of its surveillance efforts, the OIA is constantly in contact with other Exchanges, the National Futures Association and the CFTC to exchange relevant information.

OIA is comprised of five interrelated departments. The Investigations Department is responsible for investigating inquiries from customers and referrals from members, member firms and the CFTC concerning any market activity or trade practices which involve potential violations of Board of Trade rules and regulations. These investigations involve a comprehensive process of obtaining statements from witnesses and parties involved, conducting trade reconstruction reviews and analyzing trading documents. The department may close cases administratively when there is insufficient evidence of rule violations. All cases involving potential rule violations are submitted to the appropriate Exchange disciplinary committees. The department is responsible for the preparation and prosecution of cases involving its investigations.

Staff of the Investigations Department is also responsible for initiating and conducting Trade Practice Investigations ("TPIs") on a continuous basis. TPIs involve reviewing daily exception reports of the Exchange's trading activities of members and member firms to detect patterns of conduct which may indicate rule violations. TPIs are conducted utilizing the Computerized Trade Reconstruction System.

The Investigations Department also maintains a floor surveillance program that involves directly observing floor trading activity on a daily basis.

The Reporting and Research Department is responsible for auditing the Board of Trade's CTR system. It also conducts surprise on-site reviews of all audit trail data submitted by members and member firms. The department is also responsible for maintaining OIA's other various computer systems and coordinating the department's interaction with the CFTC.

The Market Surveillance Department ensures the orderly expiration of all Board of Trade contracts and monitors trading activity in order to detect attempts at price manipulation, squeezes of a commodity or corners in a market. To accomplish these tasks, Market Surveillance compiles and reviews information relating to volume, open interest, current cash commodity prices, available stocks, deliverable supply, and positions held by clearing member firms and large traders. Market Surveillance's analysis of this information identifies futures/cash price relationships which may potentially be disruptive to the marketplace. Statistical reports including historical market data are also compiled weekly.

During a month in which a futures contract is eligible for delivery or expires, Market Surveillance may be in frequent contact with major participants. With respect to stock index futures contracts, Market Surveillance communicates with members of an intermarket surveillance group that includes staff from the New York Stock Exchange, the American Stock Exchange, the Chicago Mercantile Exchange, the Chicago Board Options Exchange, the Philadelphia Stock Exchange and the Kansas City Board of Trade.

The OIA's Financial Surveillance Department ensures that all Board of Trade member firms comply with the Exchange's capital rules and capital guidelines. The Financial Surveillance Department routinely analyzes the financial health of member firms with the Simulated Analysis and Financial Exposure ("SAFE") system, the most sophisticated computerized financial surveillance program in the futures or securities industries. The SAFE system evaluates the risk of member firms at current market levels and at a variety of combinations of different market and volatility levels. The SAFE system generates approximately one hundred different reports, including but not limited to pay/collect information*/, margin data, and large trader reports. The OIA shares use of the SAFE system with the Board of Trade Clearing Corporation, which developed the system.

Any actual or potential problems discovered during the analysis results in an immediate phone call to the firm or an on-site financial review. Member firms are also required by the Board of Trade regulations to notify the Financial Surveillance Department of changes in key financial data.

The OIA Audits Department conducts biennial reviews of the books and records of each Board of Trade member firm that is registered as a Futures Commission Merchant ("FCMs") to determine compliance with Exchange rules and regulations. Audits focus on the firms' financial and compliance procedures. During a financial audit, a firm's financial condition is analyzed, along with the composition of balance sheets and capital computations to verify that the firm has appropriate procedures to ensure the continuous submission of accurate financial information to the Exchange. Also, customer balances are reviewed and the proper segregation of customer funds is verified.

The compliance portion of the audit examines a member firm's procedures for customer order preparation and processing margins, opening an account, account documentation and discretionary accounts. Cash transactions are reviewed to establish that the firm is properly accounting for customer transactions. The Audits Department also makes surprise sales practice reviews of member FCMs' branch offices and guaranteed introducing brokers. These reviews cover the solicitation of customer accounts and customer complaints.

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*/ The SAFE system currently reports this information for all U.S. futures exchanges.

One of the principal tools used by OIA to conduct its market surveillance and investigation responsibilities is the Computerized Trade Reconstruction System and its derivative system, CTR-Plus. CTR is the world's most sophisticated market audit trail. CTR documents who traded what quantity of which contracts at what price and the determined time of execution is stated to the nearest second for all (100%) of the contracts traded on the Exchange. Critically, CTR data is available within twenty-four hours. Created by the Exchange in 1986 in conjunction with the Chicago Mercantile Exchange, CTR also eliminates the possibility of individual human manipulation of times, without impairing market liquidity as would occur by requiring traders to mark execution times. CTR is the software marriage of two independent computerized trade records, the clearing trade settlement record and the price reporting time and sales journal. By eliminating reliance upon human recording of times, CTR enhances reliability of the audit trail data.

CTR-Plus is comprised of the computerized programs designed by OIA staff, member committees and outside professional consultants to monitor trade activity via computer. Although it previously relied upon statistically valid trade samples, CTR-Plus now reviews 100% of the Exchange's trading activity with a variety of sophisticated surveillance programs. These programs monitor for potential abuses such as trading ahead of customer orders ("broker frontrunning"), crossing orders, taking the opposite side of a customer order, prearranged trading, ring trading, wash sales and other similar potential violations of Exchange and CFTC trade regulations.

Simply stated, CTR is the world's best audit trail and CTR-Plus the world's most sophisticated trade surveillance program. Nevertheless, the Board of Trade recognizes that success is a journey, not a destination. Improvements are always possible. Therefore, an Exchange select oversight committee has been intensively reviewing CTR and CTR-Plus to improve their accuracy and effectiveness. Those enhancements adopted to date are specified hereafter.

Additionally, the Board of Trade and the Chicago Mercantile Exchange have agreed to combine their respective systems and expertise to create one, unified audit trail and surveillance system which can be used industry-wide. The resulting enhancements and improvements to the audit trail and related analytical systems, already the world's best, will serve as a model to other markets and a formidable deterent to any potential trade practice abusers.

THE FEDERAL INVESTIGATION

This Committee is well aware that certain members of the Chicago Mercantile Exchange and the Board of Trade have been the subject of widespread media speculation regarding a United States Attorney/Federal Bureau of Investigation ("FBI") investigation on the trading floor of both exchanges. Recent press reports also indicate that a CFTC (and possibly a federal grand jury) investigation is being conducted regarding trading activities at several New York futures exchanges. Unsubstantiated press rumors of alleged fraud at the exchanges have led some to raise concerns regarding the integrity of the Exchange's markets.

Initially, the Board of Trade does not condone -- and never has condoned -- fraud or any other trade practice abuse. The Exchange has consistently charged and sanctioned rule violators with penalties ranging from fines to suspensions and expulsions. We have developed CTR and CTR-PLUS as part of our commitment to the goal of ensuring fair and honest markets on which the public and members alike can rely. Should any federal investigation result in proven cases of fraud, we endorse and support the elimination of dishonest traders from the markets. But, at this preliminary stage, we must remember several critical facts.

First, there have been no indictments, merely subpoenas. A subpoena does not establish guilt or even a presumption of a problem, especially broad "record-retention" subpoenas of the kind issued in this investigation.

Similarly, without indictments, there obviously has been no trial, plea or conviction upon which to assess the nature and severity of rule violations, if any. Discussions of any specific rule violation, especially unsubstantiated alleged abuses of broker trading, are purely speculative at this point. At this point, reports of any abuses reside solely in self-serving, sensationalist press articles.

Thus, we cannot lose sight of what is known. What is known is that the United States Attorney has assured the Board of Trade that the Exchange itself is not the target of any investigation. What is also of record is the thoroughness and stringency of Exchange member admission policies and practices. What is established is the excellence of the Board of Trade's CTR-Plus system, a system which identified prior to subpoenas being issued the suspicious trading practices of an FBI "mole" trading as a member. Most importantly, what is evidenced by the market enhancements detailed below is the uncompromising dedication of the Board of Trade to improving its already excellent oversight and enforcement programs.

APPROVED MARKET ENHANCEMENTS

There can be no doubt that the history of the Board of Trade to this day is a unique and enviable story of success. From pioneering fair, liquid, efficient agricultural futures in the previous century to the introduction of financial futures, the creation of trading options on equity securities and the growth of the world's largest futures contracts, the Board of Trade has an unsurpassed record of achievement.

Nevertheless, the Board of Trade recognizes that innovation and improvement are on-going, evolving efforts, not merely an excuse to point with pride to past achievements. The Exchange is constantly examining its market mechanisms and surveillance techniques to insure the continued success and user confidence in our markets.

In recent months, the spotlight cast by the press revelations of a grand jury investigation intensified the Board of Trade's existing evolutionary development of market mechanism refinements and surveillance system improvements. While self-regulation and self-interest alone would require such examination, the potential for lost public confidence in the integrity of these markets demanded a redoubled effort. Consequently, numerous Exchange committees were delegated the task of a thorough review and examination of numerous issues including trade practices, trade rules, CTR and CTR-Plus refinements and membership qualifications.

That review process has culminated in twenty one (21) major recommendations which have been approved by the Board of Directors for implementation. The Exchange's Board of Directors and membership believe this program of enhancements to existing rules and systems will make significant substantive improvements to the already efficient functioning of our markets as well as help to assure that degree of public confidence necessary for the markets to function effectively. A brief description of each action follows.

Broker (Dual) Trading

It is curious and disturbing that although there has been no hint of abuses by floor brokers who also trade for their own account even in the sensationalist press accounts of the grand jury investigation, those who have long misunderstood the role and value of broker trading have chosen to use this as an "opportunity" to resurrect their objections and misconceptions. Thus, it appears that Congress must once again study and evaluate the function that broker trading performs in the markets.

The practice of broker trading, or trading as a principal and as an agent, is widespread in the United States and abroad. For example, broker dealers as well as futures commission merchants ("FCM's") trade for the firm's proprietary account and also handle customer orders. Securities specialists are not only permitted, but in some instances obligated, to trade for their own account while simultaneously executing customer orders. Thus, any examination of floor broker trading in futures contracts also should require review of the identical phenomena in the structure of FCM's, broker dealers, securities specialists and others.

Broker trading provides two principal benefits to the futures markets. First, because broker traders are permitted to trade for their own accounts, they are able to engage in trading strategies in the course of executing a customer order which result in a better price for the customer than can be obtained by a broker who does not personally trade. The Exchange's preliminary staff study of broker trading (attached hereto as Appendix 2) provides detailed examples of these trading strategies, describes the specific advantages customers derive from broker trading and presents letters from customers explaining why they prefer to have their orders executed by broker traders.

This element of preference raises the obvious but seldom articulated fact that customers can choose to have their orders executed only by brokers who do not trade for their own account if broker trading is an issue for them. Since most futures market users are commercials or large institutional investors, their ability to so choose cannot be doubted. Interestingly, as the letters incorporated herein (at Appendix 2) demonstrate, many such users strongly prefer brokers who trade for their account to execute their orders.

The second principal benefit of broker trading is that it adds substantial liquidity to the market. For example, over a three week period in fourth quarter 1988 in the Exchange's Treasury Bond futures contract, broker traders executed an average of almost 58,000 contracts per day for their own account. The Exchange's updated analysis[1] (attached hereto as part of Appendix 2) shows that futures market liquidity provided by broker trading may amount to as much as 80.0% on a daily basis across all contracts analyzed and as much as 54.0% in the Exchange's most active contracts. Because broker traders are not solely restricted to trading for their customers, they can trade for their own accounts in slower markets, during less active times of the day in a given market, or in any situation where additional market making services are needed. Thus, there are more buyers and sellers in the markets and more capital; this permits orders to be executed more easily and at lower cost. The study explains more fully the mechanisms by which this liquidity is provided by broker traders (for the benefit of all market users), presents further statistics describing the extent of broker trading activity, and explains why certain other possible means of providing market liquidity are not substitutes for broker trading.

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[1] The study notes the Exchange's objections to the definitions which the CFTC required the Exchanges to use for purposes of the data analysis. Therefore, more analysis is necessary to verify the accuracy of the data as requested by the CFTC.

Broker trading is particularly valuable to the Board of Trade because of the nature of our markets. Extensive spreading activity has characterized the contracts at the Exchange, which together with broker trading has been a key part of these particular markets and has helped them become the most efficient in the world. The price relationships among the delivery months in the grain contracts, for example, are the basis for hedging long term storage costs, an application of spreading which is an integral part of the U.S. agricultural industry. Likewise, the cost of carrying government securities can be hedged through spreading in contracts such as Treasury Bond futures at the Exchange. The role of broker traders is particularly critical in facilitating inter- and intra-market spreading, thus distributing liquidity across commodities and delivery months and forcing bid/ask spreads (customer costs) as low as possible.

In addressing concerns that potential trading abuses may be associated with broker trading, we must carefully differentiate between the valuable practice of broker trading and the potential trading abuses which may use that practice as a vehicle. By analogy, the practice of check writing is occasionally abused by some who draft fraudulent checks. Restricting or prohibiting check writing would not address the abuses, but it would destroy a valuable, legitimate economic activity. Ensuring that a sound means of detecting abuses is in place and that a stringent set of sanctions has been defined and is applied as appropriate is a more direct and logical approach to dealing with trading abuses than the restrictions or prohibitions of broker trading which some have proposed. Importantly, this approach would not damage market performance as a broker trading curb would.

It is critical to keep in mind that the Exchange's CTR-Plus system enables OIA to easily pinpoint any instances of abuse. Additionally, enhancements which have been made recently and which are planned in this system will further insure even greater deterrence of potential abuses, especially given the severe penalties which are applied if such trading abuses are detected. This self-regulatory system which combines ease of detection with strict penalties provides an effective deterrent of potential abuses which may be associated with broker trading at the Exchanges.

The experience of the domestic grain markets (principally corn, wheat, soybeans and oats) from 1983 to date is a vivid illustration of one aspect of broker trading's value. Beginning in 1984, these markets experienced a "depression" characterized by abundant domestic supply and stable prices. For the futures markets, this situation meant vastly decreased need to hedge risk (since cash market price risk was reduced) and, consequently, decreased futures market volume. For four years, floor brokers and independent traders experienced a "drought" of business and concomitant decreased opportunity to earn a living. Many were forced to leave the pit; some were forced to sell their memberships. Then, suddenly in 1988, the drought market greatly increased price uncertainty; thus, the need to hedge price risk exploded virtually overnight. With that need came increased futures orders and volume.

Critically, had brokers not been able to trade for their own accounts during the 1984, 1985, 1986 and 1987 markets, many more would have been forced to leave the pit and seek their living elsewhere. Had that happened, the 1988 market users would have found few, if any, experienced brokers to execute their orders and vastly reduced market liquidity.

Futures markets are not indestructable; they are highly fragile. Banning broker trading could well set America up to lose its ability to price its own commodities; the experience of 1984-1988 markets vividly shows how that could occur.

However confident the Board of Trade is regarding the value of broker trading and the ability to detect and punish potential abuses, we recognize that the public debate generated concerning the subject requires careful, professional analysis. For that reason, the Exchange has retained Dr. Sanford Grossman, the John L. Weinberg Professor of Economics at Princeton University, to complete a detailed, empirical study of broker trading. Dr. Grossman is a world-renowned market expert who, among other recent duties, was a primary contributor to the report of former U.S. Attorney General Nicholas de B. Katzenbach to the New York Stock Exchange following the October 1987 stock market crash. Dr. Grossman's preliminary findings are expected soon; detailed empirical analysis and a final report are currently scheduled to be completed within six months thereafter.

With expert analysis such as that provided by Dr. Grossman, Congress will be able to assess better the true value of broker trading to our vibrant but fragile futures markets. Armed with such background, we should all be in a position to determine what modification, if any, is necessary. In so doing, we must also carefully evaluate the differences in different markets.

Additionally, trade patterns and practices vary widely from exchange to exchange and even within different markets on each exchange. Therefore, only through "management by objective" - the setting of ultimate goals to be achieved by a variety of means - can regulation in this critical area function without risking irreversible damage to the markets. Since we all share the common objective of honest, liquid, efficient futures markets, the Exchange is confident that a management-by-objective regulatory approach for broker trading will work as well as this approach worked in 1986 when the CFTC adopted it for the audit trail question.

Exchange Surveillance Enhancements

The Board of Trade's market surveillance system, CTR-PLUS, is built upon the world's finest audit trail, CTR. Regardless of their excellence, CTR and CTR-PLUS are new systems, fully operational only since July, 1987. Therefore, independent of recent events, the Exchange has been evaluating improvements and enhancements to the system. These recent intensified committee reviews have already resulted in Board approval of the following significant enhancements to the systems:

(1) CTR-PLUS now reviews every trade transacted on the Exchange.

Originally, , CTR-PLUS was created (as are all standard audit systems) to review a selected, statistically valid sample of data rather than the entire data base. Recent technical advances and our long-standing commitment to improvement have now resulted in the expansion of CTR-PLUS review to every trade transacted in the Exchange's markets. This would be equivalent to the Internal Revenue Service auditing every taxpayer's return rather than the statistically valid sample which it does. The result should be not only greater effectiveness of trade practice surveillance, but also greater deterrence to any potential abusers.

(2) The Board has authorized one million dollars for CTR and CTR-PLUS improvements.

Sophisticated, effective surveillance systems require the investment of both expertise and capital. The development of CTR and CTR-PLUS was never hindered by budget restrictions. Nevertheless, to further enhance the systems will require additional funds. The million dollar fund approved by the Board evidences the Exchange's commitment to continued system enhancements.

(3) Trade bracket recordation times will be reduced fifty percent (50%).

The effectiveness of CTR-PLUS is in part dependent upon the time-bracket periods used by floor traders to time trades. Currently, thirty (30) minute bracket periods are required. The Board has approved reducing those periods to fifteen (15) minutes, a significant improvement. As a result, the already high accuracy rate of CTR times should improve even further.

(4) Market openings and closings will receive separate, five (5) minute trade time recordation brackets.

A substantial portion of the volume in any market occurs during the opening and closing periods. To further improve the audit trail and surveillance of these critical periods, the Board has approved separate five (5) minute brackets for these critical periods of trading.

(5) Trade card recording requirements have been strengthened and improved.

The CTR and CTR-PLUS systems rely in part upon the accuracy of trade data reflected on a floor trader's individual trading cards. The accuracy of those systems will be further enhanced by Board approval of new requirements: (1) all trading card records must be accounted for; (2) all trading cards must be collected by clearing firms on an hourly basis and time-stamped; and (3) all trades must be submitted to the Clearing House within one hour of collection. These steps will not only enhance the audit trail and surveillance systems, but the clearing process as well.

(6) CTR-PLUS has been technologically enhanced.

Being a computerized system, CTR-PLUS is able to be improved by technological innovations and enhancements. The Board has approved several such enhancements to CTR-PLUS including: (1) an expanded relational data base to permit more rapid investigations of trading activities extending back in time (i.e. expanding from a "snapshot" of trading activity to permit an investigator to scroll over an extended period of trading activity); (2) expansion of the number and nature of surveillance tests conducted on a routine basis; (3) use of expert systems technology which will permit investigators to quickly design programs to specific needs; and (4) expanded storage capacity which will permit rapid access to one year's data. These technological enhancements should speed investigations and increase the efficiency of professional investigator resources.

(7) All exchange floor clocks will be synchronized to an Exchange master clock.

A critical element of CTR and CTR-PLUS is accurate times. Currently, there is no requirement that the hundreds of Exchange trading floor clocks which are used to time stamp customer orders be synchronized to within ten-second intervals across the floor; therefore, minor discrepancies in times can occur which may affect CTR logic. The Board has approved synchronizing, at considerable cost, all trading floor clocks to one master clock to insure uniform, accurate time information being input into CTR.

(8) Five (5) computer programmers have been added to enhance all OIA surveillance programs.

As noted previously, the Exchange regards the self-regulatory process to be evolutionary, not static. OIA currently employs a wide variety of excellent computer programmers to assist their surveillance and investigative efforts. However, those efforts can be enhanced by the addition of new staff dedicated solely to improving existing programs and writing new ones. The Board's approval of five (5) additional programmers will greatly enhance OIA's efforts.

Office Investigations and Audit Enhancements

(9) An increase of OIA personnel by thirty percent (30%) has been approved.

OIA's staff has always maintained the highest degree of professionalism and efficiency. Because training for OIA staff positions effectively occurs only at the Exchange, hiring qualified personnel and training them expeditiously is a constant challenge. The Board has recognized that additional professional personnel to support OIA's efforts will enhance all of OIA's efforts. Therefore, the Board has approved a thirty percent (30%) increase of OIA professional staff over 1988 budgetary levels.

(10) Attorney staff exclusively supporting OIA has been tripled.

The Legal Department of the Exchange provides legal counsel to OIA as it does all Exchange departments. While all attorneys are involved in the self-regulatory process, previously only one attorney was assigned to exclusive OIA liaison and support duties. In consideration of the importance of Exchange disciplinary actions, the Board has approved tripling OIA's legal support to encompass three attorneys whose efforts are devoted entirely to supporting OIA. This increased support will increase the efficient use of OIA staff efforts.

(11) Professional investigative consultants have been approved for OIA training.

Surveillance and enforcement techniques for futures markets are more an arcane art than a precise science. The best training for new OIA staff is by existing OIA staff and Exchange members. Nevertheless, some investigative techniques are common to many markets. Therefore, the Board has approved institution of special training programs in investigation techniques for OIA staff to be conducted by non-Exchange professional consultants. The additional training should enhance OIA's existing excellent investigation efforts.

(12) OIA floor surveillance time has been increased.

Given the conjecture that the grand jury investigation is concerned with potential floor trading abuses, some question has been raised regarding whether an increased presence of OIA investigative personnel on the Exchange trading floor would enhance detection of trading abuses and provide an increased deterence to potential abusers. It has been the Exchange's experience that floor trading abuses are rare at the Board of Trade and that when they do occur, they are sophisticated and subtle enough to be detected best by fellow traders and/or sophisticated computer surveillance such as CTR-PLUS. Nevertheless, the Board has authorized additional dedication of OIA investigators to trading floor presence and observation. Although the returns on such an investment of valuable resources may be small, public confidence in floor trading integrity makes such efforts worthwhile.

Board of Directors Composition

The Exchange's Board is currently a diversified, expert body consisting of twenty-four (24) representatives from all aspects of the membership, industry and general public. The Rules of the Exchange require and foster that diversity. For example, Rule 102.00 requires that the committee which nominates Director candidates "... give special consideration to the desirability of having all interests of the Association represented on the Board." Moreover, the Nominating Committee itself is elected from the diverse Exchange membership which includes individual traders, FCMs, broker-dealers, banks, commercial firms, institutional investors and others.

Thus, the Board of Directors currently is comprised twenty-four (24) members which fall into the following categories:

(1) three (3) non-members from the general public sector (which have included a former United States Attorney General, a Nobel Prize winning economist, the chairman of a national agricultural association and other similar nationally respected public figures);

(2) three (3) non-resident members who, being required to have their principal place of business more than fifty (50) miles from Chicago, effectively are quasi-public Directors;

(3) eight (8) member Directors who are currently principals or officers of member firms and thus represent the FCM/broker-dealer community;

(4) six (6) Directors whose principal occupation is as brokers executing customer orders on the floor of the Exchange;

(5) three (3) individual members whose principal occupation is as active traders on the floor of the Exchange for their personal accounts (i.e. a "local" trader); and

(6) the President of the Exchange, a non-member Exchange officer with no vote and no trading privileges.

Thus, the Board is currently very diversified representing all aspects of the industry as well as the general public.

Any criticism of the Exchange's Board as being biased toward members or one aspect of the membership is simply contrary to the facts. Furthermore, present Rules and policies will insure continued diversity of representation; no new rules or legislation are required.

Nevertheless, the Exchange's Board has enhanced its authority and policies in two significant ways.

(13) Board fining authority has been increased more than three hundred percent (300%).

As described previously, the Board of Directors sits as the ultimate disciplinary body of the Exchange, either in an appellate capacity or by referral from a committee. Historically, the Board has always found its authority to suspend, expel and otherwise sanction to be more than adequate. However, with the growth of institutionalized trading and the consolidation of member firms, the Board concluded that its current fining authority ($75,000 per violation) may not be sufficient in all instances to adequately sanction abuses, especially where larger capitalized respondents are involved. Therefore, the Board has approved for a membership ballot vote increasing its fining authority more than three hundred percent (300%) to $250,000 per violation.

(14) The Board has reaffirmed through formal resolution its long-existing policy of excluding members with histories of significant trade practice abuses from participation on the Board and major Exchange disciplinary committees.

The Board has long had a policy barring members with a history of significant trade practice sanctions from participation on the Board itself or on either of the Exchange's major disciplinary committees, the Floor Governors and the Business Conduct committees. The Exchange is committed to maintaining the utmost integrity of the self-regulatory disciplinary process and those who administer it. To insure that there is no doubt concerning this continuing commitment, the Board has approved a formal resolution approved by the Exchange's Rules Committee reaffirming and formalizing this long-existing policy.

Floor Practice Enhancements

The Board of Trade has historically adopted all its Rules, especially trade practice rules, to meet the highest standards of both integrity and market efficiency. Existing rules proscribe unjust and inequitable trade practices, forbid trading ahead of customer orders, insure that any profit resulting from the erroneous execution of a customer order goes to the customer, prohibit pre-arranged and accommodation trades, as well as prohibit all other forms of trade abuse. The Exchange believes that these existing Rules are more than sufficient to deal with all potential trade practice abuses. Nevertheless, as part of the on-going review of all Exchange operations, the Board has approved several enhancements to floor practice regulation.

(15) All broker associations must be registered with the Exchange.

Associations of floor brokers sharing profits, expenses and losses -- particularly with the inclusion of local traders -- do not exist at the Board of Trade to the best of the Exchange's knowledge. Such associations do exist at other Exchanges and present those Exchanges with unique self-regulatory challenges to insure market integrity. The potential for abuse of customer orders and market efficiency due to broker groups is, therefore, not present at the Board of Trade.

However, some independent brokers at the Exchange do share order decks to facilitate customer order execution especially in options contracts where liquidity in deep out-of-the-money options is thin. Others share the expense of common clerks. To insure that these arrangements do not evolve into potentially abusive ones, the Board has approved that all associations of brokers which share income must register with the Exchange providing certain information to enhance surveillance of their activities.

The Board is committed to preventing any potential abuse of customer orders which would result from the otherwise legitimate business relationships of member floor brokers.

(16) The Exchange has approved a modified closing call rule to enhance the efficiency of the market close.

Market-on-close orders, if entered late, can create problems in achieving an efficient, narrow and accurate closing range. Efficient closing ranges are essential to the commercial usage of futures contracts, especially as a pricing mechanism for cash market transactions. The addition of the modified closing call provides an opportunity for such late entered orders to be completed and for individual floor traders to "even-up" after providing liquidity for closing orders. Also, a more efficient closing range facilitates a more accurate settlement price which frequently is the basis for cash market pricing.

New Regulation 1007.02 would establish an additional two-minute trading period for all contracts at the conclusion of trading sessions. During this period, transactions could take place only at prices within the previously established closing range. No new orders could enter the pit, but cancellations would be permitted. Stop orders and limit orders elected by the closing range could be filled during this period.

The Exchange believes that the establishment of a modified closing call will benefit public customers for a number of reasons. First, more efficient closing ranges benefit cash market pricing. Additionally, because the new procedure will enable individual floor traders more readily to adjust their positions (to "even-up"), they will be more willing to provide liquidity to the closing public orders at the most competitive prices. Finally, no trade made during the modified closing call would be advantaged over those made previously in the market due to the restriction of prices to those established previously by the closing range.

The Exchange also notes that the audit trail for the modified closing call will be precise because the closing call period will receive a separate CTR designation, thereby enhancing the Exchange's surveillance capabilities for this period.

(17) The Board has approved prohibiting floor clerks from having trading accounts.

Floor clerks are responsible for the clerical handling of customer orders and other trade documents. While having no trading privileges, clerks are nevertheless intimately involved in the trading process. Because of that involvement, clerks are often tempted to trade for their own account. While such trading has historically served as a valuable means of apprenticeship training to become a member, the Board has determined that the rights of membership trading must be restricted to those who pass the intensive membership admission process. Therefore, the Board has approved prohibiting floor clerks from maintaining trading accounts.

Additional Technological Enhancements

The Board of Trade has not limited technological innovation to the creation of CTR and CTR-Plus. The Board of Trade is one of the most technologically advanced marketplaces in the world. Two aspects of that technological supremacy are worth noting in the present context.

(18) The Exchange's electronic order-entry system ("EOS") will not only increase the efficiency of customer order execution and clearing, but also the accuracy of CTR.

For many months, long before the current news of a grand jury investigation, the Board of Trade has been developing an advanced, electronic order-entry system ("EOS"). Electronic order-entry will speed communication of customer orders to the trading floor, expedite confirmation of execution back to the customer, and submit trades for clearing directly. These enhanced efficiencies will not only serve customers better and reduce FCM expenses, they will also provide a computerized record of customer orders with times accurate to the second. This enhanced timing will improve the accuracy of the CTR audit trail and, therefore, the efficiency of the CTR-Plus surveillance system.

Approved by the Exchange membership on November 10, 1988, EOS is now on a prototype basis. As use of the system grows, accuracy of CTR data will be enhanced even further.

(19) The Board has approved further, intensive investigation and development of a hand-held trading terminal.

Just as EOS will enhance customer order time data, a hand-held computer terminal to replace trading cards would not only provide on-line clearing of trades, but also unimpeachable trade execution timing to the nearest second. However, no current technology exists to create such a device for use in the auction market. For this reason, the Board has approved significant expenditures of Exchange staff and member committee time to work with outside professionals in developing such a terminal to meet the needs of our markets. Preliminary work has already begun. Hopefully, these efforts will lead to the development of suitable technology within a few short years.

H.R. 2869

On July 12, 1989, Chairman English and Representatives Coleman and Penny introduced the "Commodity Futures Improvements Act of 1989," H.R. 2869 (attached hereto at Appendix 4). The bill proposes to amend the Commodity Exchange Act (*inter alia*) to improve the regulation of futures and options trading, restrict potential customer abuses, reinforce development of exchange audit trails and establish higher standards for service on governing boards and disciplinary committees of self-regulatory organizations.

During a June 29, 1989 press conference preceding the introduction of the bill, Chairman English noted that this Subcommittee's inquiry "found that the system as a whole is sound" and that "the real goal is to produce strong incentives to the industry so that we can protect against these kind of wrongs." Representative Coleman stated that the focus of this proposed bill is the "restoration of integrity which has been questioned by the media and customers."

The Chicago Board of Trade concurs wholeheartedly in the objectives of the bill and the approach of providing incentives to the industry to protect against potential market abuses. However, several provisions of the bill present seriously damaging approaches to achieving our common objectives. If enacted, these proposals could prevent U.S. futures markets from serving their public interests and meeting successfully the challenge of foreign competition. Therefore, we urge the Subcommittee to re-examine and revise several proposals, especially those relating to dual trading and audit trails.

Dual Trading

H.R. 2869 proposes (in pertinent part) amending Section 4j(1) of the CEA (7 U.S.C. 6j) to prohibit dual trading by a floor broker in any contract market trading in excess of 7,000 contracts per day based on a six month moving average. The CFTC may increase or decrease that threshold level based upon a determination that the prohibition upon dual trading creates undesirable price volatility, unacceptable widening of bid-ask spreads or otherwise threatens the public interest.

Under Section (D), the bill proposes to permit the Commission to exempt a board of trade from the dual trading prohibition if the exchange can demonstrate to the Commission that the Exchange's audit trail can detect "*any and all* instances of trading violations which the Commission determines to be attributable to dual trading and is *fully* verifiable." (Emphasis added.)

Section (C) of the bill requires the Commission to periodically determine whether dual trading should be permitted and, if so, under what terms and conditions, for those contract markets trading below the 7,000 contract per day level. Section (B) of the bill sets forth the determinations the Commission must make in those contract markets where dual trading is prohibited. Subsection (vii) provides a floor broker may dual trade if a customer designates an individual floor broker by name in writing on at least an annual basis.

Initially, any proposal to ban dual trading should be studied carefully subject to extensive expert input. As discussed previously, dual trading provides a valuable market function which should not be summarily abrogated without extensive input and evaluation. At a minimum, this Subcommittee should review, consider and have hearings regarding the Commission's study of dual trading as well as those of other experts in the field.

Assuming the Subcommittee deems it necessary to proceed without the benefit of such background, any restriction of dual trading should be predicated principally upon the ability of the Exchange to detect potential abuses. The audit trail exemption contemplated by subsection (D) of H.R. 2869 provides the framework for such an approach. However, the specific provisions contained in the bill provide an unrealistic and unworkable standard for conditioning dual trading.

By requiring the audit trail to detect "any and all" potential dual trading abuses and be "fully" verifiable, the bill establishes a standard of perfection unobtainable in the real world. Instead, the bill should be modified to reflect the objective of excellence shared as a goal by Congress, the Commission and the entire industry. The current industry audit trail is the best in the world. The Subcommittee should not lose sight of the system's existing excellence by insisting on unattainable perfection.

Improvements and enhancements are possible. Included herein is a detailed description of an extensive program of such audit trail enhancements already implemented by the Exchange. These enhancements will achieve the bill's objective of improved audit trails (an objective shared by the Board of Trade) without presenting the potential for the destruction of contract market liquidity.

The bill's audit trail exemption should be revised to be more realistic without sacrificing the common objective of maximum detection of potential trade abuses. Such revisions should include the following:

(1) prohibit dual trading unless an exchange can demonstrate that its audit trail is verifiable to the nearest minute to at least the 90% level as determined during the CFTC's periodic rule enforcement reviews;

(2) those brokers whose customers have expressly required in writing that their brokers shall not dual trade will be prohibited from dual trading; and

(3) should an exchange fail to achieve the audit trail performance standard, dual trading will be prohibited in those contract months which do not attain the standard until compliance can be demonstrated, unless the contract month displays low liquidity. The prohibition will not apply to those brokers who are predominantly spread brokers. For purposes of this prohibition, a member is classified as a broker or a trader on a daily basis and, intra-day, is not classified a broker until he makes his first customer trade of the day. This prohibition applies by separate contract month, for futures and options contracts separately. Members handling customer orders functioning in a clerical capacity shall be deemed to be brokers for purposes of this rule.

If these revisions are adopted, the common objective of audit trail enhancement and detection of potential dual trading abuses can and will be met. Critically, this common objective will be met without risking the destruction of market liquidity and the loss of American markets to foreign competitors.

Audit Trails

Section 201 of the bill proposes (in pertinent part) to amend Section 4g(2) of the CEA (7 U.S.C. 6g) by requiring that the trade time execution required by the section be verifiable and stated within a one minute increment within one year of enactment and a thirty (30) second increment within three (3) years of enactment. Paragraph (b) of the bill amends Section 5 of CEA (7 U.S.C. 7) to condition contract market status upon this requirement.

As stated earlier, the Board of Trade shares the Subcommittee's desire to have the best audit trail obtainable which does not negatively impact the functioning of the market. Requiring standards unobtainable by present technology only sets up the market place for failure, to the detriment of all involved. Deferring the requirement provides no solution because there is no assurance that technology will develop sufficiently in the interim to meet the standard.

The Subcommittee's objectives would be better served by simply requiring that the audit trail be sufficient to properly monitor the market and detect potential trading abuses. The self-

regulatory exchanges and the Commission are in the best position to determine the particular specifications of that requirement. As Chairman English has stated, "precise audit trails and responsive time reconstruction for trading are absolute necessities ...." Precision and responsiveness, then, should be the standard, not an unobtainable fixed requirement.

SRO Disciplinary Committees

The bill proposes in Section 209 to amend Section 8c of the CEA (7 U.S.C. 12c) to require that exchange disciplinary committees be comprised so that for any given hearing, a majority of the hearing panel shall be of a different trading status than the respondent. Trading status is divided between floor broker or floor trader, non-floor members and staff (if any).

The effect of the proposal will be to render exchange disciplinary proceedings unfair and ineffective. A fundamental premise of British-American jurisprudence is the requirement of trial by one's peers. The Committee's proposal legislates precisely the opposite: trial by those guaranteed to be unfamiliar and inexperienced with the standards applicable to the respondent's conduct and the conditions under which the respondent's actions were taken. For example, if the respondent is a broker in the corn futures pit, he will be judged by a panel whose majority is not now (and likely never has been) engaged in floor trading of corn futures, far less brokering in that contract. Not only is floor trading itself (and brokering in particular) a unique and complex activity, customs and practices may well vary even among different contracts.

Surely the best judges of one's conduct are one's peers. Given that, it is contrary to reason and the best interests of the marketplace to require a disciplinary panel to be comprised of a majority of non-peers.

Presumably these provisions of the bill are aimed at removing the perception of some unarticulated bias in the current structure of exchange disciplinary panels. The Board of Trade is unaware of any problem of this nature, whether real or perceived. However, if the Subcommittee is convinced (for reasons not evident) that changes must be made to the structure of exchange disciplinary panels, the provisions for Board of Trade arbitration panels provide a better model than that proposed in the bill. (See e.g., Board of Trade Regulation 610.01). Those rules provide that five members of the committee be chosen for each exchange arbitration panel from four major categories: (1) floor traders; (2) floor brokers; (3) brokerage firms; and (4) commercial firms. Such a model presents significant problems in the disciplinary context which are not applicable to the arbitration process.

Nevertheless, it is a better means of insuring the necessary degree of relevant industry expertise on a disciplinary panel than the provision of the bill.

The section also provides that Exchanges deny membership on the Board of Directors or any disciplinary committee to those guilty of a "major violation of any rule" within a period of time to be determined by the Commission and requires the classification of Exchange rules as "major" or "minor" for this purpose.

The Exchange has no objection to this provision; as set forth above, the Board of Trade already has formalized its long-standing policy prohibiting members with significant histories of trade practice abuses from membership on the Board or on Exchange disciplinary committees. However, the Exchange notes that the arbitrary classification of rule violations as "major" and "minor" may distort the gravity of any given offense without due consideration to the facts of each individual case.

Broker Associations

Section 102 of the bill proposes to amend Section 4j of the CEA (7 U.S.C. 6j) to restrict trading among broker associations as that term may be defined by Commission regulation.

As detailed above, broker associations as they exist at other exchanges are not common at the Board of Trade and present no present trade practice problems. The Exchange, however, does share the Subcommittee's concern that associations of brokers that are established for legitimate business purposes not be permitted to evolve into abusive entities. Therefore, the Exchange makes no comment on this provision of the bill at this time.

Public Representation on Governing Boards

The bill proposes to amend Section 5a of the CEA (7 U.S.C. 7a) to require that "outside members" as defined by the Commission comprise at least twenty percent (20%) of the governing board of each contract market.

Given the diverse representation of the Exchange's Board of Director's as detailed above and the rules, regulations and policies insuring that diversity, the Exchange makes no comment at this time on this provision of the bill.

Registration of Floor Traders

Section 205 of the bill proposes to amend Section 2(a)(1)(A) of the CEA (7 U.S.C. 2) essentially to extend the requirements of floor broker registration to all floor traders.

In view of the Exchange's rigorous member admission process as described above, the Exchange makes no comment at this time on this provision of the bill.

Other Provisions of H.R. 2869

The Exchange makes no comment at this time regarding any of the other proposed provisions of the bill.

CONCLUSION

The combination of sophisticated computerized surveillance systems and the vested self-interest of the Exchange's rigorously screened membership in the preservation of market integrity combine to create an extremely effective mechanism for the detection of potential exchange trading floor abuses. The Board of Trade has never condoned -- and does not condone today -- any trade practice abuse. Proven offenders have always been appropriately sanctioned (including fines, suspensions and expulsions).

Nevertheless, the Board of Trade recognizes that success is an evolutionary process, not a static one. Thus, despite creating CTR and CTR-PLUS -- the world's finest audit trail and surveillance systems -- the Exchange has considered all means to preserve and improve market integrity. The result of the most recent, intensive internal study is the twenty one (21) point program of enhancements detailed herein. These improvements (and others still under consideration) will insure that the Board of Trade's markets remain the world's most efficient, liquid and economical with the highest degree of integrity and professional participation.

In considering these issues, we urge this Subcommittee to remain mindful of the potential (indeed, likely) consequences of precipitous, hastily considered action. While currently the world leader in futures markets, the U.S. could easily lose this unique and valuable industry to eager foreign competitors, if ill-considered regulation is mandated. Therefore, critically valuable trade practices such as broker trading must be carefully evaluated, especially where their value is indisputably documented and no evidence exists regarding any abuses.

In fashioning any legislation, this Committee should also look with pride to the precedent set in 1986 regarding the audit trail issue. Then, the CFTC goal of one-minute time identification was left to each separate exchange, with its differing membership and markets, to best determine how to meet that goal. The result of this management-by-objective approach was the creation of CTR, the world's finest audit trail. If Congress acts similarly now after careful study, the result should be the continued improvement of what are already the world's most honest, liquid and efficient futures markets. This is the goal we all share.

Several of the provisions of H.R. 2869, especially those relating to dual trading and audit trails, appear ill conceived to achieve the stated objectives of the bill, objectives shared by the Board of Trade. Instead of the prohibition of dual trading in our most important markets, the Subcommittee should condition dual trading upon the ability of the contract market to maintain a precise, excellent audit trail, not an unobtainable and nonexistant perfect system. If such an approach is adopted, everyone's common objective of market integrity and liquidity can and will be achieved.

APPENDIX 1

Table 1

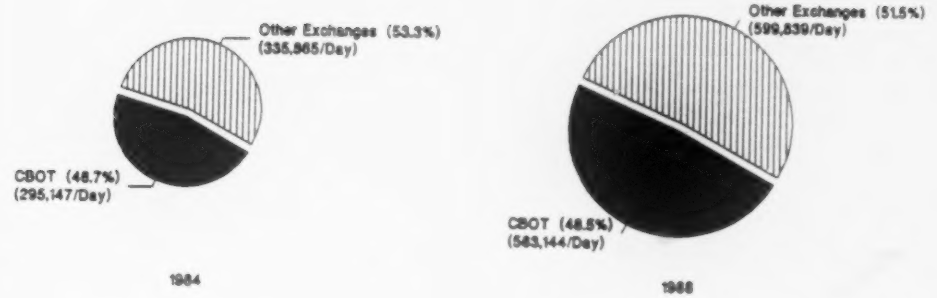
Volume Growth Rates: U.S. and World Futures Exchanges; 1984-1938

	Average Daily Volume		Growth
	1984	1988	Rates (%)
CBOT	295,147	563,144	90.8
Other U.S. Futures Exchanges	335,865	599,839	78.6
Foreign Futures Exchanges	152,000	495,549	226.0
U.S. Market Share	80.6%	71.7%	
Foreign Market Share	19.4%	28.3%	

Figure 1

CBOT Market Shares of U.S. and World Futures and Futures Options Volume; 1984 vs. 1988

U.S.



WORLD

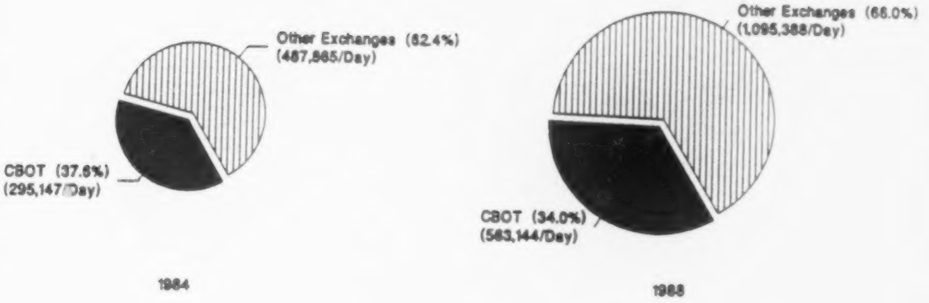


Table 2

Contracts Trading at the World's Futures Exchanges

U.S. Futures Exchanges	1984	1985	1986	1987	1989
No. of Contracts Listed	94	108	120	124	127
Growth Rate (%)		14.9	11.1	3.3	2.4
Foreign Futures Exchanges					
No. of Contracts Listed	125	129	172	178	230
Growth Rate (%)		3.2	127.7	3.5	29.2

Table 3

Ten Most Actively Traded Contracts on Futures Exchanges Worldwide 1985-1989*

Rank	1989*	1988	1987	1986	1985
1	Chicago Board of Trade TREASURY BOND FUTURES	Chicago Board of Trade TREASURY BOND FUTURES	Chicago Board of Trade TREASURY BOND FUTURES	Chicago Board of Trade TREASURY BOND FUTURES	Chicago Board of Trade TREASURY BOND FUTURES
2	Chicago Mercantile Exchange Eurodollars	Chicago Mercantile Exchange Eurodollars	Chicago Board of Trade TREASURY BOND OPTIONS	Chicago Board of Trade TREASURY BOND OPTIONS	Chicago Mercantile Exchange S&P 500 Futures
3	NY Mercantile Exchange Crude Oil Futures	Chicago Board of Trade TREASURY BOND OPTIONS	Chicago Mercantile Exchange Eurodollar Futures	Chicago Mercantile Exchange S&P 500 Futures	Chicago Board of Trade TREASURY BOND OPTIONS
4	Chicago Board of Trade TREASURY BOND OPTIONS	NY Mercantile Exchange Crude Oil Futures	Chicago Mercantile Exchange S&P 500 Futures	Chicago Mercantile Exchange Eurodollar Futures	Chicago Mercantile Exchange Eurodollar Futures
5	Tokyo Stock Exchange Japanese Government Bonds	Tokyo Stock Exchange Japanese Government Bonds	Tokyo Stock Exchange Japanese Government Bonds	Tokyo Stock Exchange Japanese Government Bonds	NY Commodity Exchange Gold 100 oz.
6	MATIF French Government Bonds	Chicago Board of Trade SOYBEAN FUTURES	NY Mercantile Exchange Crude Oil Futures	NY Commodity Exchange Gold 100 oz.	Chicago Board of Trade SOYBEAN FUTURES
7	Chicago Board of Trade SOYBEAN FUTURES	MATIF French Government Bonds	MATIF French Government Bonds	NY Mercantile Exchange Crude Oil Futures	Chicago Mercantile Exchange Deutschemark Futures
8	Chicago Mercantile Exchange S&P 500 Futures	Chicago Mercantile Exchange S&P 500 Futures	NY Commodity Exchange Gold 100 oz.	Chicago Mercantile Exchange Deutschemark Futures	Chicago Board of Trade CORN FUTURES
9	NY Commodity Exchange Gold 100 oz.	Chicago Board of Trade CORN FUTURES	Chicago Board of Trade SOYBEAN FUTURES	Chicago Board of Trade CORN FUTURES	NY Commodity Exchange Silver 5000 oz.
10	Chicago Board of Trade CORN FUTURES	NY Commodity Exchange Gold 100 oz.	Chicago Board of Trade CORN FUTURES	Chicago Board of Trade SOYBEAN FUTURES	Chicago Mercantile Exchange Swiss Franc Futures

*January - March, 1989.

Table 4

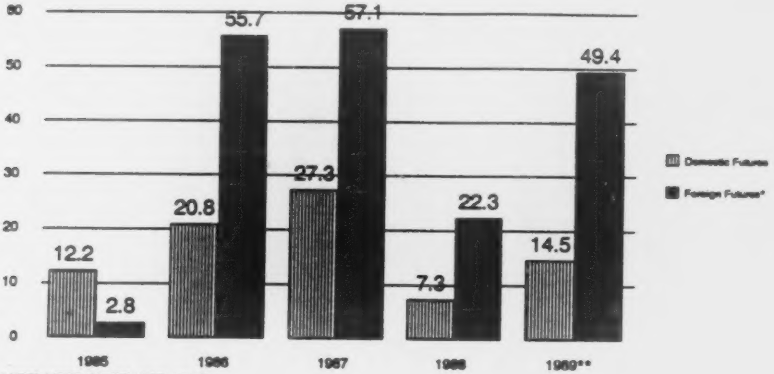
Number of Foreign Futures and Options Contracts
Traded in the Top 25 by Volume in the World; 1984-1989*

1984	1985	1986	1987	1988	1989*
0	0	1	3	4	6

*January-March, 1989

Figure 2

Annual Growth Rates; 1985-1989**
U.S. Futures Industry vs. Principal Foreign Futures Exchanges*
(percent)



* TSE, LIFFE, MATIF, SFE, SIMEX

** January - March

Table 5

Volume Growth of Financial Futures and Options Contracts Trading on Foreign Futures Exchanges 1985 - 1989*

	1985	1986	1987	1988	1989*
Government Bond Futures and Options					
Average Daily Volume	13,686	77,980	171,723	189,751	218,038
Growth Rate (%)	--	469.8	120.2	10.5	14.9
Stock Index Futures and Options					
Average Daily Volume	1,590	6,655	59,914	47,428	75,305
Growth Rate (%)	--	318.6	800.3	-20.8	58.8

*January-March, 1989

Table 6

FOREIGN COMPETITION

Treasury Bond Futures Volume; Chicago Board of Trade
and London International Financial Futures Exchange
October 1, 1987 to October 30, 1987

	Chicago Board of Trade			LIFFE
Date	Night Session	Day Session	Total	Total
10/01/87	23,466	261,753	285,219	5,970
10/02/87	9,047	368,448	377,495	995
10/05/87	10,963	267,009	277,972	4,336
10/06/87	7,623	244,259	251,882	7,890
10/07/87	10,522	362,278	372,800	8,525
10/08/87	10,626	442,189	452,815	6,891
10/09/87	15,363	308,742	324,105	7,775
10/12/87*	10,370	84,586	94,956	3,391
10/13/87	14,887	278,275	293,162	6,317
10/14/87	12,100	511,021	523,121	14,482
10/15/87	19,270	640,217	659,487	12,538
10/16/87	21,967	365,532	387,499	2,461
10/19/87	28,892	483,949	512,841	13,503
10/20/87**	28,269	34,487	62,756	47,082
10/21/87	44,552	311,180	355,732	15,955
10/22/87	13,933	366,911	380,844	12,465
10/23/87	28,266	323,253	351,519	16,079
10/26/87	19,203	272,409	291,612	12,529
10/27/87	20,937	280,655	301,592	13,398
10/28/87	15,270	337,029	352,299	10,900
10/29/87	15,542	224,911	240,453	9,537
10/30/87	17,400	220,040	237,440	7,352
Average Daily (Year-To-Date)	12,385	286,505	297,121	6,186

* Columbus Day; Banks and some financial institutions closed.
** Day session locked limit up.

(Additional attachments are held in the committee files.)

150 GRAIN EXCHANGE BUILDING MINNEAPOLIS, MINNESOTA 55415
TELEPHONE (612) 338-6212

**Minneapolis
Grain Exchange**

TESTIMONY

of

**JAMES H. LINDAU
President
Minneapolis Grain Exchange**

Mr. Chairman and Members of the Subcommittee,

I am James H. Lindau, President of the Minneapolis Grain Exchange. This Exchange was established in 1881. It is an active cash grain trading center, and maintains futures contracts and options on Hard Red Spring Wheat and futures contracts only in White Wheat, Oats, and High Fructose Corn Syrup.

I note that representatives from six other exchanges have already testified before this Committee in connection with this year's CFTC reauthorization. I will limit my remarks to issues of major concern to the Minneapolis Grain Exchange.

First, a general comment. I am the newcomer in representing an exchange in a setting such as this but I am familiar with business and government. The futures industry today -- with all its size, strength and variety -- owes much of its growth and credibility to the action of this Committee in 1974. In that year you crafted legislation to create an exclusive, independent regulator to regulate the nation's future markets. The child of that legislation, the Commodity Futures Trading Commission, has done a good job under difficult circumstances. However, we are concerned that parts of this bill serve to revise the 1974 mandate and put micro-management of some aspects of the industry in the Congress and out of the hands of the expert regulator. This appears to me to be bad business and bad government.

Specifically, dual trading is essential to preserving liquidity in our futures contracts. Dual traders are involved in every aspect of futures trading at the Minneapolis Grain Exchange. They cannot be separated from trading in the current option, or spreading against deferred options, and permit retention of any semblance of liquidity. If dishonesty springs from dual trading, we must increase our vigilance to prevent it (even though there is no evidence of dishonest dual trading at the Minneapolis Grain Exchange.) If dishonest dual trading springs from highly liquid, active futures markets, let us identify and punish the dishonest traders, but let us not, in the process, destroy the futures markets. These markets have provided the best, and often the only, source of pricing information and margin protection dating back almost to the Civil War.

Technology is reaching the point that very accurate, timely audit information is available to help identify those traders who might try, unfairly, to do better than their trading skill alone might permit. At the Minneapolis Grain Exchange, we believe that our audit program provides a satisfactory means by which to verify the timing data submitted to the Clearinghouse and to detect inaccurate or missing trade data on source documents.

In this regard, the Commission, during its 1988 Rule Enforcement Review of the Minneapolis Grain Exchange, found that the Exchange's one minute timing system was extremely accurate. The CFTC stated, "... the Exchange's overall average accuracy rate was 96.8 percent." We believe that an accuracy rate of 90% or greater is a proper target, and will, of course, continue to strive to maintain a high level of performance in this area.

Let me take a minute to congratulate Mr. Cherry and his staff on their professionalism. We were visited at the Minneapolis Grain Exchange by Mr. McDonald who was competent and thorough. It is our view that the fruits of this long, detailed investigation should be fully used by the Committee as part of its responsibilities to oversee the CFTC. In the main, the CFTC has more than enough statutory authority in the areas of so called "dual trading", audit trail and composition of boards at exchanges. I think it is entirely appropriate for this Committee to review the record of the CFTC on these issues; it would be very risky to incorporate your concern in statutory mandates.

Testimony of

Sanford J. Grossman

Executive Summary

Dual trading is said to occur when an entity sometimes trades as a broker for customers, and at other times trades for its own account. Dual trading is quite pervasive throughout the United States securities and futures markets as well as in financial and commodity markets throughout the world. The pervasiveness of dual trading is due to the fact that many of the skills and facilities required to be a good broker are also necessary to be a good trader. Dual trading increases the supply of both brokers and floor traders because a dual trader can earn income from two activities to cover the costs of training, an Exchange seat, and time spent on the floor. He has less idle time and facilities when he can switch from the activity in low demand to the activity in high demand.

Dual trading has both a direct and an indirect effect on the quality of customer services. The direct effect is an increase in the quality and quantity of brokers. The fact that dual trading increases the supply of brokers means the customer has more brokers to choose from and at a lower price. Furthermore, using a broker who is a good trader means higher quality executions for customers.

The indirect effect derives from the increase in the liquidity of the market caused by the increase in the number of market makers. Parties who trade for their own account by buying at a low price and selling at a high price serve a market making function. Thus the ability for an entity to use its facilities for proprietary trading results in an increased presence of market makers on the floor at times when their services are most needed. More traders standing ready to trade make for a more liquid market with smoother price changes.

In order to aid in a comparative analysis of dual trading I distinguish two types of dual trading. The first type, called simultaneous dual trading occurs when a firm trades as a principal for its own account, and an agent for its customer in the same transaction. This type of dual trading is prevalent in securities markets, currency and interest rate swap markets, and the fixed income market. Simultaneous dual trading does not take place in futures markets. The second type of dual trading called consecutive dual trading occurs when a firm trades for customers as an agent and at other times trades for its own account as a principal, but the firm does not do both in the same transaction. Consecutive dual trading occurs in futures markets, as well as in all of the markets in which there is simultaneous dual trading.

Dual trading plays a particularly important role in futures markets as contrasted with securities markets. The fact that all trading in futures takes place on the exchange floor and that spread trading is an important part of hedging strategies make the skills of a trader more necessary for a good futures broker. The immediacy required by the futures market makes liquidity more important, and therefore makes a larger supply of market makers more critical.

There are three types of brokerage services the customer needs. The first service ("search") involves searching for the parties who are interested in being on the other side of the trade (i.e., the contra-party). The second service ("timing") involves obtaining and processing information to determine how long to wait for the arrival of the most advantageous contra-party while being exposed to the risk of an adverse price move. The third service ("bargaining") involves actively bargaining among available contra-parties to obtain the best price.

A securities broker can use his skills and sales force to prearrange trades "upstairs". Upstairs search is often an effective substitute for the downstairs working of an order where "timing" and "bargaining" skills are needed. A futures broker cannot prearrange trades upstairs. The brokerage firm cannot substitute "search" skills for trading skills. The order must be worked on the Exchange floor. The floor broker must have the ability to trade in such a way on the floor of the Exchange that he brings the other side of the trade to the floor at a good price for his customer. Therefore floor trading skills are relatively more important in the futures market than in the securities market.

Further, much futures trading involves "spreads" where a customer wants to buy and sell two (or more) contracts simultaneously for a guaranteed net price. The customer's broker can execute the spread by trading with a "local" on the floor, or the broker can execute the individual "legs" of the spread consecutively. The latter will be in the best interest of his customer if the broker is a skilled trader, since, by trading each leg himself, the broker avoids paying the local a premium for the risk in trading the spread. Such spread trading is inherently risky to a broker, since after he executes one leg of the spread his customer can hold him to a price for the other leg of the spread, which the broker may find impossible to achieve if the price moves after he does the first leg. This aspect of futures trades as well as the relatively higher underlying price volatility in many futures contracts increase the trading skills burden on a futures floor broker relative to that of a securities floor broker.

Futures trading customers often have a high demand for immediacy because they are trading to hedge an underlying spot market position. The fact that immediacy of trade execution is extremely important to futures customers implies that they will have a greater demand for market makers than will be the case in markets where the cost of delayed execution is smaller. A commodity hedger bears great risk if he does not do his futures trade immediately. This risk may force him to trade using a "market" order, for example to sell immediately to the highest bidder currently available. If there are few market makers then he will receive a relatively low price, i.e., his trade will have a high market impact cost. Thus futures markets have a great demand for traders who in effect serve a market making function. The institution of dual trading permits this demand to be met at low cost.

Dual trading increases the supply of the types of customer services which are relatively most demanded by futures customers. Dual trading is prevalent in the securities market, both on the floor and off the trading floor. Institutional securities trades are often prearranged off of the floor, and this lessens the burden of securities floor brokers. It would be quite peculiar to eliminate dual trading for futures and maintain it for securities where the dual trading by floor brokers is less important. The elimination of dual trading from futures markets will harm customers by reducing the quality of brokers who do customer business. The best traders will trade for their own account, leaving customers with brokers who are less skilled traders. By preventing traders from acting as brokers, the elimination of dual trading will reduce the number of floor traders, and thus reduce market liquidity. Foreign markets will gain an advantage over US markets causing large customers to leave US markets which will lose liquidity. Therefore small customers, unable to trade overseas, will be most adversely affected by the loss of liquidity in US markets. Spot markets, such as grains and the US treasury bond market will be adversely affected by the loss of liquidity in futures markets, and spot prices will become more volatile. Finally, customers will lose the freedom of choice they now have to pick either a broker who also trades for his own account, or a broker who trades exclusively for customers.

AN ECONOMIC ANALYSIS OF DUAL TRADING

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1. Executive Summary

Dual trading is said to occur when an entity sometimes trades as a broker for customers, and at other times trades for its own account. Dual trading is quite pervasive throughout the United States securities and futures markets as well as in financial and commodity markets throughout the world. The pervasiveness of dual trading is due to the fact that many of the skills and facilities required to be a good broker are also necessary to be a good trader. Dual trading increases the supply of both brokers and floor traders because a dual trader can earn income from two activities to cover the costs of training, an Exchange seat, and time spent on the floor. He has less idle time and facilities when he can switch from the activity in low demand to the activity in high demand.

Dual trading has both a direct and an indirect effect on the quality of customer services. The direct effect is an increase in the quality and quantity of brokers. The fact that dual trading increases the supply of brokers means the customer has more brokers to choose from and at a lower price. Furthermore, using a broker who is a good trader means higher quality executions for customers.

The indirect effect derives from the increase in the liquidity of the market caused by the increase in the number of market makers. Parties who trade for their own account by buying at a low price and selling at a high price serve a market making function. Thus the ability for an entity to use its facilities for proprietary trading results in an increased presence of market makers on the floor at times when their services are most needed. More traders standing ready to trade make for a more liquid market with smoother price changes.

In order to aid in a comparative analysis of dual trading I distinguish two types of dual trading. The first type, called simultaneous dual trading occurs when a firm trades as a principal for its own account, and an agent for its customer in the same transaction. This type of dual trading is prevalent in securities markets, currency and interest rate swap markets, and the fixed income market. Simultaneous dual trading does not take place in futures markets. The second type of dual trading called consecutive dual trading occurs when a firm trades for customers as an agent and at other times trades for its own account as a principal, but the firm does not do both in the same transaction. Consecutive dual trading occurs in futures markets, as well as in all of the markets in which there is simultaneous dual trading.

Dual trading plays a particularly important role in futures markets as contrasted with securities markets. The fact that all trading in futures takes place on the exchange floor and that spread trading is an important part of hedging strategies make the skills of a trader more necessary for a good futures broker. The immediacy required by the futures market makes liquidity more important, and therefore makes a larger supply of market makers more critical.

There are three types of brokerage services the customer needs. The first service ("search") involves searching for the parties who are interested in being on the other side of the trade (i.e., the contra-party). The second service ("timing") involves obtaining and processing information to determine how long to wait for the arrival of the most advantageous contra-party while being exposed to the risk of an adverse price move. The third service ("bargaining") involves actively bargaining among available contra-parties to obtain the best price.

A securities broker can use his skills and sales force to prearrange trades "upstairs". Upstairs search is often an effective substitute for the downstairs working of an order where "timing" and "bargaining" skills are needed. A futures broker cannot prearrange trades upstairs. The brokerage firm cannot substitute "search" skills for trading skills. The order must be worked on the Exchange floor. The floor broker must have the ability to trade in such a way on the floor of the Exchange that he brings the other side of the trade to the floor at a good price for his customer. Therefore floor trading skills are relatively more important in the futures market than in the securities market.

Further, much futures trading involves "spreads" where a customer wants to buy and sell two (or more) contracts simultaneously for a guaranteed net price. The customer's broker can execute the spread by trading with a "local" on the floor, or the broker can execute the individual "legs" of the spread consecutively. The latter will be in the best interest of his customer if the broker is a skilled trader, since, by trading each leg himself, the broker avoids paying the local a premium for the risk in trading the spread. Such spread trading is inherently risky to a broker, since after he executes one leg of the spread his customer can hold him to a price for the other leg of the spread, which the broker may find impossible to achieve if the price moves after he does the first leg. This aspect of futures trades as well as the relatively higher underlying price volatility in many futures contracts increase the trading skills burden on a futures floor broker relative to that of a securities floor broker.

Futures trading customers often have a high demand for immediacy because they are trading to hedge an underlying spot market position. The fact that immediacy of trade execution is extremely important to futures customers implies that they will have a greater demand for market makers than will be the case in markets where the cost of delayed execution is smaller. A commodity hedger bears great risk if he does not do his futures trade immediately. This risk may force him to trade using a "market" order, for example to sell immediately to the highest bidder currently available. If there are few market makers then he will receive a relatively low price, i.e., his trade will have a high market impact cost. Thus futures markets have a great demand for traders who in effect serve a market making function. The institution of dual trading permits this demand to be met at low cost.

Dual trading increases the supply of the types of customer services which are relatively most demanded by futures customers. Dual trading is prevalent in the securities market, both on the floor and off the trading floor. Institutional securities trades are often prearranged off of the floor, and this lessens the burden of securities floor brokers. It would be quite peculiar to eliminate dual trading for futures and maintain it for securities where the dual trading by floor brokers is less important. The elimination of dual trading from futures markets will harm customers by reducing the quality of brokers who do customer business. The best traders will trade for their own account, leaving customers with brokers who are less skilled traders. By preventing traders from acting as brokers, the elimination of dual trading will reduce the number of floor traders, and thus reduce market liquidity. Foreign markets will gain an advantage over US markets causing large customers to leave US markets which will lose liquidity. Therefore small customers, unable to trade overseas, will be most adversely affected by the loss of liquidity in US markets. Spot markets, such as grains and the US treasury bond market will be adversely affected by the loss of liquidity in futures markets, and spot prices will become more volatile. Finally, customers will lose the freedom of choice they now have to pick either a broker who also trades for his own account, or a broker who trades exclusively for customers.

2. Introduction

Dual trading is said to occur when an entity sometimes trades as a broker for customers, and at other times trades for its own account. This paper explores the economic function of dual trading, and proposes methods for calculating its impact on market liquidity and the quality of customer brokerage services. A later paper will implement those methods on actual trading data.

The structure of this paper is as follows:

Section 3 provides some general background on the organization of markets and trading. It will be seen that dual trading is pervasive in the United States securities and futures markets, though futures markets can be distinguished from securities markets by the fact that dual trading is permitted off the trading floor in securities while it is prohibited for futures. The Appendix provides a summary of the extent to which dual trading exists on markets throughout the world.

Section 4 provides an economic analysis of the determinants of the effectiveness of markets. It examines the demand for, and the supply of various brokerage services. It also explains the determinants of market liquidity.

Section 5 shows how dual trading impacts on the ability of brokers to deliver the above services, and how dual trading impacts on market liquidity.

Section 6 applies the above analysis to determine the likely consequences of eliminating dual trading in futures markets.

Special attention is given to evaluating proposals to selectively eliminate dual trading in particular commodities or contract months.

Section 7 discuses various methods which can be used to compute the monetary benefits to customers from the existence of dual trading.

3. Customer Order Flow and Market Structure

Dual trading can best be understood by tracing the manner in which a customer order is executed. It is convenient to begin with a customer who wants to buy an "item". This item might be a futures contract, a listed security, a government bond, etc.

Discussion of Table 1

Table 1 presents the first part of the path which the order can traverse. Part A of the Table analyzes the order flow if the customer gives his order to a dealer, while Part B considers the case where the order goes to a broker. In Part A, the customer deals with a principal, while in Part B, the broker acts as the customer's agent.

Part A1 is the simplest case, where the customer trades directly with the dealer. This type of trade is characteristic of the fixed income market, for example US treasury bonds, municipal bonds, corporate bonds, etc. It is also the method by which the spot and forward market in foreign exchange, and interest rate swaps operate. In such markets, the customer trades directly with a dealer. As will be elaborated in the next section, the customer must engage in active search to find the dealer who is offering him the best price. He is not employing an agent to do the work for him.

Table 1

With Whom Does the Customer Initiate His Trade

A. Customer Uses a Dealer.

A1. The customer can trade directly with a dealer who sells to him from the dealer's inventory.

A2. The customer can trade directly with a dealer who obtains the item elsewhere.

A2a. The dealer could obtain the item from another dealer who has it in its inventory.

A2b. The dealer could obtain the item from another customer.

A2c. The dealer could obtain the item indirectly from another customer by obtaining it from a dealer who obtains it from another customer.

B. The customer can use a broker to find a buyer.

B1. The broker can find a seller on an Exchange.

B2. The broker can find a seller from its own customers.

C. The Customer uses Broker/Dealer Services.

The Broker/Dealer executes its customer's order by selling from its own account and by finding customers who want to sell.

Part A2 considers the case where the customer desires an item which the dealer does not have in his inventory. In such a case the dealer will attempt to obtain the item from another dealer, or from another customer. That is, the dealer is acting like a broker by engaging in efforts to obtain the item for his customer. Therefore even in pure dealer markets, brokerage services are provided. More importantly, it is impossible to distinguish trades made on behalf of a customer from trades made on the "brokers" own account. The broker/dealer almost always trades ahead of his customers in a pure dealer market. The broker/dealer must do so in order to obtain the item for his customer.

Part B of Table 1 considers the case where the customer uses a broker to obtain the item for him. The clearest example of this situation occurs with regard to futures contracts. A customer desiring to trade a futures contract, is prohibited by CFTC regulations from trading directly with a dealer off of the floor of an Exchange. The customer must engage the services of a broker to act as his agent. This is labelled B1 on Table 1.

A more complex situation is summarized by B2, where the broker can find a seller from among its own customers. An important example of this phenomenon occurs in the institutional trading of common stock. A customer who desires to purchase a large block of common stock may ask an NYSE member firm to attempt to find sellers. The member firm will utilize various information sources to locate existing holders of the stock who might be sellers. The member firm will then bring both the buy and sell orders of its customers to the NYSE floor where the orders will be crossed.

Part C of Table 1 considers the case where the customer uses the firm to be simultaneously a broker and a dealer. This was already implicit in the "pure" dealer relationship described in Part A2, but it can be very explicit in the case of securities. Consider the example mentioned above where the NYSE member firm is putting together the purchase of a large block of stock for a customer. If the broker/dealer cannot find enough customers who want to sell, it might sell out of its own inventory, and thus takes part of the other side of its own customer's trade. It would then bring the whole trade to the NYSE floor for open outcry.

The above remarks indicate that securities are traded by firms that engage in a type of dual trading which I will refer to as simultaneous dual trading. That is, the firms are being both brokers and dealers at the same time for the same customer. It may be useful to contrast this with what I will call consecutive dual trading in which the firm sometimes trades as principal and sometimes trades as agent, but does not do both in a single transaction. Simultaneous dual trading occurs in the securities markets (including options) but does not occur in the futures markets.

A customer in the securities or futures industry will use a firm which does one or the other of the above types of dual trading. The economics of why this is the case will be analyzed in the next two Sections. Here it suffices to note that just about every firm which accepts customer orders also trades for its own account; there are very few firms that trade only for their own account, or that trade only for customers. This is literally true in the dealer markets like the fixed income markets and the over the counter stock market (where the distinction between principal and agent trades does not exit), but it is also true for common stock and futures contracts.

Discussion of Table 2

Table 2 traces the next step followed by the customer's order under the assumption that it is not executed directly by the broker/dealer accepting the order. In particular, the order is traced through its execution on an Exchange. It is convenient to refer to the broker who first receives the customer order as the "upstairs broker". It is conceptually useful (and usually descriptively accurate) to visualize the upstairs broker transmitting the order "downstairs" to the trading floor of an Exchange, or transmitting it to a computerized "Exchange" (such as the NASDAQ "over the counter", or Instanet "markets"). The recipient of the order on the Exchange floor can be a pure "agent" on the Exchange floor who never trades as a principal (category A on Table 2), or it can be a floor broker who does both customer business and also trades for his own account as a principal (category B on Table 2).

Table 2

Tracing the Customer's Order On An Exchange

A. Customer's order handled by an AGENT on the Exchange floor.

A.1 Employee of the Exchange executes the customer's order.

A.2 Floor broker who specializes in trading for customers executes the customer's order.

B. Customer's order handled by a PRINCIPAL/AGENT on the Exchange floor.

B1. A broker/dealer handles the order.

B1a. The broker/dealer handles it as an agent.

B1b. The broker/dealer handles it as an agent and principal.

B2. A broker/trader handles the order as an agent.

B3. A broker/market maker handles the order.

B3a. He handles it as an agent.

B3b. He handles it as a principal.

The purest form of an "agent" who executes the customer's order on the Exchange floor is an employee of the Exchange who executes customer orders (category A1 in Table 2). This occurs on many foreign Exchanges (such as the Tokyo Stock Exchange), as well as on the Chicago Board Options Exchange (CBOE) where an Exchange employee maintains a limit order book for customer orders, and handles the execution of these orders when the market price reaches the level at which the customer indicated that he is interested in trading. Note that by "executing the customer order", I do not mean that he takes the other side of the trade. Rather, the agent follows the prescribed rules of the Exchange in an attempt to get the best price for the customer. This may involve announcing to the trading crowd that he has an order to fill, and then trading with the member of the trading crowd who offers the best price. The member of the trading crowd with whom the agent trades may [illegible] be representing customers as an agent or he could be trading for himself as a principal.

Part A2 of Table 2 indicates a less extreme situation where a member of the Exchange decides to specialize in trading for customers on the floor, and essentially does no trading as a principal for its own account. Almost all Exchanges have individual members who have built a reputation as good brokers trading for customers, but who do little or no trading on their own account.

In contrast to the above situations where the customer order is handled by "agents", an enormous amount of floor brokerage is effected by firms that are broker/dealers, broker traders, or broker/market makers. These categories appear in Section B of Table 2. An example of category B1 is a broker/dealer such as Merrill Lynch who handles a customer's stock trade on the NYSE Exchange floor. The Merrill broker can act as a pure agent (category B1a on Table 2) who buys the stock on the Exchange from another broker in an open outcry auction. In a more complex case, Merrill may be both a principal and an agent; selling to the customer partially from its own account and partially for other Merrill customers. For large institutional trades, the Merrill floor broker may be representing Merrill Lynch, and both buying and selling customers on the NYSE floor at the same time in the same trade. Merrill negotiates the trade secretly upstairs, and exposes the orders "downstairs" on the trading floor by offering out one side of the trade to whomever is present at the specialist post.

Categories B1a, and B1b indicate that the broker dealer may handle the order as an agent (not taking a part of the trade on its own account), or in contrast as in the above example, the firm may be acting simultaneously as a principal and an agent in executing the customer's order. In the situation where the broker/dealer acts as both a principal and an agent, it is engaging in what I call simultaneous dual trading. In the case where it executes this customer's order as an agent, it may be engaging in consecutive dual trading, since at some other time it may be trading in the stock as a principal.

In order to further emphasize the distinction between these types of dual trading, Table 2 contains the additional category, B2 of "broker/trader". A broker/trader is a floor trader who sometimes trades on his own account as principal, and at other times trades as a broker for customers. He is not a "dealer" in that he does not take the other side of customer trades. He is a consecutive dual trader but not a simultaneous dual trader. As noted earlier, consecutive dual trading is permitted on futures markets, but simultaneous dual trading is not permitted. In contrast, both types of dual trading occur on the floor of securities Exchanges.

The final category of Table 2, labelled B3, concerns the situation where a designated market maker handles the customer order. For example, on the NYSE, the upstairs broker may give the "specialist" (who is a broker's broker, and a market maker on the NYSE floor) a customer order. The specialist may handle this order as an agent and find the other side of the trade among other floor brokers (category B3a in Table 2). On the other hand, the specialist may act as a principal, and take the other side of the trade on its own account. Thus the specialist can engage in simultaneous dual trading.

Summary

A customer's order for securities or futures will usually be handled by firms engaged in dual trading. This is the case at the "upstairs" level where the customer order arrives at a securities broker/dealer or Futures Commission Merchant (FCM), each of whom trades for its own account as well as for customers. However, it is also the case at the "downstairs" level on the trading floor where the customer's order is handled by a specialist, broker/dealer, or broker/trader, each of whom engages in some form of dual trading.

It should not be surprising that firms which develop facilities for trading on their own account will also be able to provide high quality executions for customers. In the next Section, I explain why it is the case that good executions of customer orders often involve substantial trading skills.

4. The Determinants of Market Liquidity and Brokerage Services

4A. Brokerage Services

Consider a customer who desires to trade. He may desire "dealer" and/or "brokerage" services. We will see below that it can sometimes be difficult to distinguish dealer from brokerage services. There are three types of "brokerage" services the customer needs. The first service ("search") involves searching for the parties who are interested in being on the other side of the trade (i.e., the contra-party). The second service ("timing") involves obtaining and processing information to determine how long to wait for the arrival of the most advantageous contra-party while being exposed to the risk of an adverse price move. The third service ("bargaining") involves actively bargaining among available contra-parties to obtain the best price.

The above three activities (or services) are performed in obvious ways in some markets, but in a subtle manner in other markets. For example, the sale of a house often requires the use of a broker who advertises the house and searches for buyers. The owner of the house must decide whether to accept the first offer he receives or delay the sale until other potential buyers (hopefully willing to pay more than the current buyer) are found. Finally, the seller must bargain among the buyers to try to obtain the highest price.

Brokerage Services For Institutional Securities Customers

The institutional securities market provides another example of brokerage services. A portfolio manager may desire to hedge his portfolio of stocks buy purchasing put options. He might want 10,000 SPX index options. These options trade on the CBOE, and the typical trading volume in the particular option of interest might be 1,000 options per day, and the quotation on the option may show 100 options offered at $3.00 per option. The portfolio manager will call the index products department of a broker/dealer. The broker will call its trader on the Exchange floor to ascertain at what price 10,000 options can be purchased on the floor. Typically, the price will be higher than the $3.00 shown on the quotation screen at which only 100 options were offered for sale. At this point, the broker will use its knowledge of its other customers' trading desires to search for a better price than is being offered on the floor. It may find customers willing to sell 9,000 options at $3.00. It may then "accommodate" the customer by selling 900 options from its own account. The broker will then bring the order down to the floor of the CBOE and bid for 10,000 options for a price of $3.00. Assuming that the crowd on the trading floor is still only offering 100 options, the broker will sell 900 from its own account, and 9,000 from its other customers, effectively crossing the order on the Exchange floor. Note that the broker engaged in a dealer function in order to better provide brokerage services to its customer.

It should be emphasized that the "search" function is intimately related to the "timing" function. The customer is subject to the risk that the market will move against him while he tries to get a better price than is currently offered on the Exchange for the large number of options which he is attempting to buy. He also bears this risk, if he and the broker engage in bargaining to attempt to get a higher price. It is crucial that his broker have a "feel" for the potential price movements, and also knowledge about the prices at which his own customers are willing to sell. If the broker acts as a dealer by selling some options from his own account to accommodate the customer, then he must also have the same kinds of knowledge and ability. To summarize, the institutional brokerage function will be performed most effectively by a firm with the skills and knowledge of a trader. For trades which cannot simply be sent to the Exchange for immediate execution (i.e., as a "market" order), the broker is not merely a clerk. He must engage in all of the activities, and have all of the skills of a trader.

The search function is even more important for the market in individual common stock. A buyer of a large block of common stock must often find sellers off of the Exchange floor. Here again the information brokers have about sellers will be crucial. First, the brokers can review public documents which provide the names of large institutional holders of the stock. The broker can then solicit selling interest from them. Second, the brokerage firm can call upon the knowledge of its sales force which stays in day-to-day contact with investors, and thus comes to know something about who is willing to sell and at what price.

In the securities market a broker can directly contact potential trading partners who are not present on the Exchange floor and he is thereby able to gain information for his customer about the costs and benefits of delay. The fact that it is possible and necessary to gain off-floor information distinguishes the activities and necessary skills of securities brokers, from futures brokers. Though any floor broker can communicate with his upstairs office, futures markets are distinguished from securities markets by the fact that price discovery occurs exclusively on the trading floor for futures, while price discovery occurs upstairs as well as downstairs in the securities market. Unlike securities brokers, futures brokers cannot secretly prearrange trades upstairs, and thus the futures floor broker must trade in such a way as to bring the other side down to the trading floor, as is analyzed below.

Brokerage Services for Futures Customers.

Consider a grain storage firm which desires to hedge its position. The broker who receives this order will transmit it to the futures Exchange. He is prohibited by regulations from working the order "upstairs". The broker who executes the trade on the trading floor must carry the full burden of "search", "timing", and "bargaining". For example, if the order is to sell 3 million bushels at a time when only 100,000 bushels are being bid for $3.00, then the floor broker must trade in such a way that he induces buyers who may be "upstairs" to send orders to the floor. This is an implicit form of "search". The broker could simply announce that he has 3 million to sell, and hope that the other floor brokers will call potential customers "upstairs" to induce buying. However, unlike securities, commodity futures brokers may have less information about their customers underlying interest in particular positions. This information is often proprietary and strongly related to the underlying business operation of the commodities customer. Thus, the only effect of announcing that he has 3 million bushels to sell will be to cause a large fall in price which will give the customer a poor (if any) execution.

The situation is further complicated by the fact that the customer may be bearing extreme risk while the broker delays the execution of the trade in an attempt to get a better price. The fact that futures customers are often hedging underlying commodity or securities positions means that they can face greater risk from delayed executions than a securities customer. In the above example, the grain storage firm's overall profitability will suffer greatly if grain prices fall before it can hedge its inventory.

The floor broker can sell some futures, perhaps driving the price down a little. The fall in price communicates "through prices" that the market needs buyers. The prices at which trades occur on the Exchange are communicated to the world. A customer (off of the Exchange floor) who was not interested in buying at the previous price may become interested in buying after seeing trades at lower prices. The floor broker is thus using his trading to indirectly communicate with potential customers who are off of the trading floor. This is an alternative mechanism to that which occurs in the trading of securities where much communication occurs upstairs on the telephone between brokers and their customers.

The futures broker attempting to sell 3 million bushels will sometimes find it necessary to disguise the true intention and size of his order. No buyer wants to buy from the broker just before the broker sells 2 million bushels. A broker who keeps selling in an attempt to generate buying interest can actually cause buying interest to disappear. For this reason a broker may find it advantageous to occasional intersperse his customer sell orders with buy orders for his personal account. This helps disguise his intentions. The effective execution of the customer order involves a subtle interplay between communicating a desire to sell in an attempt to attract buyers, while disguising the full size of the order.

The floor broker on the futures market can only bargain with those present on the floor. At each stage of the execution of his customer's order he can accept the bids currently being made, or he can make a counter-offer. He bargains through open outcry with the trading crowd on the Exchange floor. This is in contrast with the securities market, where a floor broker can seek better bids "upstairs".

The above remarks indicate that the floor broker on the futures market must have all of skills of a good trader in order to give his customer a high quality execution. A person who trades for his own account on the Exchange floor makes money by being able to judge where the market is going to move in the short run. A floor broker's greatest fear is that the market will move away from him (for example, that the existing bids will disappear and be replaced by lower bids) while he delays execution of his customer's order in an attempt to get him a better price. The ability to judge short run market movements is thus at the essence of being a good floor broker and being a good trader.

Summary

The distinct characteristics of a futures market imply that a futures broker must behave like, and have all the skills of a trader. This is much more the case than in securities markets where a broker can effect a good execution for his customer by the use of a its upstairs sales force which brings both sides of the trade together. The key skills if the floor trader are "timing" and "bargaining" - these are used in place of upstairs "search" to obtain a contra party for his customer at the best price.

4B. The Determinants of Market Liquidity

The quality of brokerage services is only one of the determinants of the quality of order execution. A customer can have an excellent broker, but if the market in which the broker executes the trade is illiquid, then it will be very difficult to get a good execution. Therefore an understanding of the quality of customer order execution requires an understanding of the determinants of market liquidity.

Clearly, markets serve the function of enabling parties to engage in trade. However this is not the only function of markets. Markets serve a price discovery function: providing and aggregating information across both active and inactive market participants.

These points can be clarified by temporarily making the following artificial distinctions. Divide the potential market participants into three groups: brokers, market makers and final customers. Pure brokers are agents, who by definition, never take a position in the instrument being traded, and I have discussed them extensively in the previous section. Market makers, by definition, take a position only for short term trading profits, i.e., the average return from a position held for the long run will not reward them for the risk of capital committed over the long run relative to other uses they have for their capital. Final customers, by definition, are willing to accept the average returns for the risk of their positions over the long run, and are trading perhaps with great current immediacy to achieve that position. This division of actors is obviously artificial, but it will help to explain some important concepts.[1]

Final Customers

The final customer could be a bond dealer who sells bond futures to hedge a portfolio of bonds in its inventory. The customer faces the risk that bond prices will fall before he is able to sell the bonds in his inventory. He insures against this risk by selling bond futures. He bears the risk of a price fall while his broker attempts to fill his order on the Exchange floor. This customer may be willing to accept no return on average from being short the bond future. He is willing to take a zero or even negative expected return position because of the insurance provided by the position. In particular, if bond prices rise, then his losses on the bond futures are offset by gains on the bond inventory.

In the securities market, the final customer might be a money manager who wants to add a particular industry group to its portfolio of common stock. This type of customer demands less immediacy of order execution than does the futures customer who is trading to hedge a position. The money manager does not hold a large group of assets that are necessarily going to enjoy a price move in the opposite direction from the price move in the stocks that are being purchased. Though there may be some diversification effect leading to a risk reduction from a securities trade, it tends to be much smaller than the risk reduction effected by a commodity futures hedge.

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[1] See Sanford Grossman and Merton Miller, "Liquidity and Market Structure," The Journal of Finance, July 1988, Vol. 43, No. 3, p.617-37.

Market Makers

The market maker could be a dealer buying at a price from which it expects high abnormal returns. The market maker buys the instrument in situations when the price is temporarily low, while the final customer buys the instrument because (a) the long run average return is high relative to its risk, or (b) the reduction in risk of his overall portfolio compensates for the low expected return of buying the instrument. More precisely, the market maker takes positions because of the variability in the expected return (buying when expected returns are high and selling when expected returns are low), while the final customer takes positions based upon the long run average expected return. Many trading institutions who are usually final customers in the above definition, will function as market makers when there are clear variations in expected returns. For example an S&P 500 Index Fund may substitute futures for stock when futures are trading at a discount relative to stock. The fund is taking a position in the spread because the spread has a temporarily high (risk adjusted) expected return.

To better understand the role of market makers, consider the following example. For reasons unrelated to information about future payoffs, a group of equity holders desires to sell a substantial block of equity. Assume that a negligible price fall would be required to induce the rest of the economy to increase its equity holding by the amount that is to be sold. That is, if final buyers could be matched with final sellers, then there would be no price impact of the trade. However, the potential final buyers are dispersed throughout the economy (if not the world), and are not in constant communication with the market. A market maker will buy the offered stock into his inventory to bridge the time interval between the arrival of the sellers and buyers. He bears risk while the stock is in his inventory, and hence must, on average enjoy a reward.

A market maker (or final customer, behaving like a market maker) buys when expected returns are high (relative to the normal risk adjusted return for the asset), and sells when expected returns are low. A large unanticipated flow of sell orders which occurs in the absence of information about future payoffs, will lower price and raise expected returns (in the absence of market maker intervention). It is the fall in price, in the absence of news, which signals to the market makers (and eventually the final buyers) that their intervention is necessary. The price move is a crucial signal for allocating resources. The buying activity of market makers trying to take advantage of the high expected returns will diminish the size of the price fall, and thus stabilize the market.

Market makers engage in exactly the same activities in the futures market. The only important distinction for our purposes is that the activity only occurs on the Exchange trading floor in the case of futures, while it can also occur off of the Exchange floor in the case of securities. Therefore the market makers on the floor of a futures Exchange are the only source of liquidity for a futures customer, while there are also off-floor sources of liquidity for securities customers.

Markets as Information Conveyors

The ideal market would be one in which everyone in the economy could costlessly, effortlessly, and continuously participate. In such an ideal market there would be no brokers (and they surely would disagree with this definition of ideal), because there would be no search for contra-parties. There would also be no market makers, since no one is needed to bridge the gap in time between the arrival of buyers and sellers at the market; all potential buyers and sellers are always costlessly and effortlessly present. Unfortunately, discussions of ideal markets can be sterile, as I feel are discussions about ideal worlds without wars, earthquakes, bad weather, or government regulators.

A major factor which causes markets to deviate from the ideal is the fact that continuous participation and information retrieval and evaluation is neither effortless nor costless. If one party wants to sell, this information is not costlessly disseminated to, and processed by all potential buyers. More importantly no single person is being made aware of the collective demand and supply schedules of the rest of the market.

The fact that we are not all part of this fantastic, telepathic network creates the need for information to be provided by markets and broker/dealers, as well as the need for market makers.

Market makers take a position in the instrument, and bridge the gap in time between the arrival of the final sellers and buyers. In the absence of a large supply of market makers, a customer order will have a large "market impact" cost of execution. This cost is the fall in price caused by a sellers demand for immediate order execution, and the rise in price caused by a buyers demand for immediate order execution.

The market impact of a trade clearly depends on how the trade is executed. There are two reasons for this. First, orders which demand immediate execution convey information to other participants. Market participants know that one reason that a trader demands immediate execution is that he has information, they thus offer to trade at adverse prices with the trader who demands immediacy. Of course, immediacy may be demanded for other reasons, such as a liquidity or hedging need. The weight put on the information motivation for the trade will determine the size of the market impact of the trade. The market impact of a trade depends on the method by which it is executed for a second reason, namely if a final customer is not present to take the other side of the trade, then someone must earn a return from taking the other side of the order into his inventory. This return is to cover the risks and other costs of maintaining an inventory, and the market maker earns this return by taking the other side of the trade at an adverse price to the customer. This adverse price move is the market impact of the trade.

The greater are the number of market makers, the smaller will be the market impact of a given customer order. The impact is smaller not only because of the increased competition, but also because each market maker can take a smaller fraction of the customer's order into his inventory when there are more market makers. The smaller is the position that a market maker is asked to take, the more willing he is to trade at a price which does not disadvantage the customer (for example., a market maker will be willing to buy at a higher price, the less he is asked to buy, since he has a smaller inventory and thus less risk).

The number of market makers available to take the other side of a customers trade will be determined by the costs and benefits of market maker activities. The costs of market making involve
(a) the cost of capital to carry (or margin) positions;
(b) the costs of training;
(c) the cost of the time spent on the trading floor.
Anything which reduces the cost of market making will raise market liquidity, and lower the market impact cost to customers of effecting their trades.

Summary

The quality of execution available to a customer will depend on the quality of the brokerage services provided to him as well as the underlying liquidity of the market in which he trades. The floor brokerage services needed by a futures customer involve the broker in the use of trading techniques which only a skilled trader will have mastered. The (1) inability to prearrange trades "upstairs" for futures customers and (2) the great demand for immediacy inherent in a hedge transaction, imply that floor trading skills are relatively more important to the typical futures customer than to the typical securities customer. Further, the above two characteristics of futures trading also imply that the liquidity of the Exchange floor will be relatively more important for futures than for securities customers. Anything which can reduce the cost of market making will thus tend to be relatively very important for achieving quality futures trade executions for customers.

5. Dual Trading, Market Liquidity, and the Quality of Brokerage

The economics of brokerage services and market liquidity outlined in Section 4 provide the basis for understanding the pervasiveness of dual trading discussed in Section 3.

The previous discussion showed that the skills of timing and bargaining are important both for the broker in getting the best execution for his customer and for a market maker trading for his own account. It should be added that a broker who trades for customers bears risk. This risk occurs because he agrees to execute limit orders, spread orders, and stop loss orders for customers. If he fails to execute these orders as agreed then he will have to make up the losses to his customer.[2] The institution of dual trading permits an individual to use his time, skills and risk bearing capacity for two activities, namely market making and customer brokerage. In order to engage in trading, a person must bear the costs of training, an Exchange seat, and the time spent on the trading floor. A system in which the trader can earn a return from these costs by spreading his talent and energies over two activities will clearly encourage more people to be engaged in the activities. Thus the institution of dual trading increases both the supply of market makers and of brokers.

Therefore dual trading has both a direct and an indirect effect on the quality of customer services. The direct effect is that it increases the pool of brokers available to customers who are skilled at providing the services of search, timing, and bargaining. The indirect effect is that it increases the supply of market makers, so that even if the customer's order is not executed by a dual trader, his broker will be able to provide the above services at lower cost because of the increased liquidity provided by the increased number of market makers.

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[2] For example, if the broker accepted a limit order to buy at a price of $3 or below, and a trade occurs at $2.90 afterwards, and then all trades occur at prices above $3.00, then the broker will be held accountable by his customer for a price between $2.90 and $3.00.

The Importance of Dual Trading in Futures Markets

Dual trading has a particularly important function in futures markets in the United States for three reasons. First, various regulations make the Exchange floor of the futures market the only focal point of trade. Second, the nature of many types of futures trades would make it very difficult to search for contra-parties "upstairs", even if such activities were permitted. Finally, the high degree of immediacy demanded by many futures customers both increases the advantages of using a skilled floor trader as a broker, and also the advantages of having a liquid market on the Exchange floor. These points are elaborated upon below.

The Exchange Floor is a Focal Point In Futures Markets

It is a violation of CFTC regulations for trades to be arranged off of the trading floor. Hence the only source of liquidity to customers is the liquidity provided on the Exchange floor. This should be distinguished from the situation which prevails in securities markets. A securities customer who, for example, wants to sell a large block of stock can use the services of "upstairs" brokers to search for buyers off of the Exchange floor. Eventually, the broker will find buyers and possibly commit its own capital as a buyer, and bring the trade down to the floor of the stock Exchange to be crossed. The "upstairs" securities broker is able to search for buyers without revealing to the world how much its customer is interested in selling. Further, he can provide information to his customer regarding what price can be obtained for the block. In a futures market this type of information can only be obtained by careful trading. There is a greater burden put on futures floor brokers than is put on securities floor brokers. Performing the tasks of timing and bargaining are more difficult on futures markets than on securities markets because the absence of upstairs search places all the burden on floor brokers. In particular, the futures broker must extract information through his trading that would have been extracted by the securities broker through telephone calls.

Another important consequence of the fact that the futures pit is the focal point of trade is that potential buyers and sellers do not have to search among upstairs brokers for the best price; they need only look to the trading floor. Though a futures floor broker must work hard to communicate his clients need to the world through trading, this has the effect of enhancing the value to the world of the observed prices at which trades occur on the futures floor, i.e., price discovery takes place on the trading floor. This is in contrast to the securities market where much institutional price discovery takes place in secret upstairs. If a trade is negotiated upstairs, then this is done in secret, and the rest of the world is not informed until the trade is brought down to the Exchange floor to be crossed.

The fact that futures markets put a heavy burden on floor brokers means that there is a greater need for skilled floor traders in such markets. The skills needed by a floor broker are very similar to the skills needed by someone trading for his own account. The ability to sometimes work as a broker and other times work as a trader increases the rewards that a skilled trader can earn, and hence increases the number of such traders present on the Exchange floor.

It should be emphasized that the CFTC regulations prohibiting "upstairs" trading are not the only reason that a futures Exchange tends to be more of a focal point of trade than is the case for a stock Exchange. The fact that a futures customer's hedging needs are intimately related to secret aspects of its business will make it relatively more difficult for brokers to know where to find contra-parties to a futures trade, than it is to find contra-parties to a securities trade. A grain exporter who has just signed an agreement to deliver wheat to a foreign country, and may thus have a great desire to have a long futures position, will not tend to publicize this fact. This is in contrast to a money manager who desires to add an industry group to its portfolio over the next few weeks. The latter is likely to be revealed to securities brokers. Thus it is more likely that securities brokers know where to look for the "buy" side of the trade in the above securities example, than that they could discover that the grain exporter is a potential buyer in the commodity example. The contrast is even more extreme when a broker needs to find the sell side. In the case of common stock, the broker can find all large institutional holders of the stock (from form 13F filling made with the SEC) and solicit a sale from them. No corresponding holders of short commodity positions need exist. The very fact that there are "shares outstanding" of equities is in contrast to futures where "short" and "long" positions must be created by customers. The existence of the shares outstanding creates shareholders (i.e., potential sellers) who can be directly contacted by brokers, in contrast to futures where all potential creators of "short" positions would have to be contacted in an attempt to find a seller.

Futures Customers Require Brokers Who are Traders

Many futures orders are for "spread" trades. A spread trade involves selling one contract and buying another contract. For example a customer currently holding a short Treasury bond contract for June expiration may want to buy the June contract and simultaneously sell the September contract, i.e., he wants to buy the June/September spread. This type of trade is very common because, unlike common stock, futures contracts expire. A customer who wants to maintain his hedged position must "roll" his position into the next contract month (by trading out of his position in the contract which is about to expire, and simultaneously trading into the same position in a contract with a later expiration). Note that the customer will give the order to the broker as a single spread trade, rather than as two separate trades because the customer does not want to bear the risk of a price move while only one "leg" of the trade is being executed.

The customer's broker has two choices in executing a spread trade. He can trade with a market maker who sells him the spread at a specified price, or he can "leg" the trade himself by, for example, selling the September contract first, and then waiting for a propitious time to buy the June contract. For example, suppose the customer gave him the order to buy the spread for 3/32 which means to pay 3/32 more for the June contract than he receives from selling the September contract. There may be a market maker on the floor who is willing to sell the spread for 3/32. However, the customer's broker sees that the June contract is being offered at 96-07, and the September contract is bid for 96-04 and offered at 96-06.[3] So he decides to buy the June for 96-07 immediately, and offer the September at 96-05, with the hope of saving his customer 1/32. If he is right in his judgment of the market then he will be able to sell the September at 96-05, but if he is wrong then he may have to sell at 96-04 or below. If the market moves against him before he can sell the September at 96-04, then he will have to pay his customer for the difference between 96-04 and the price he executes the trade.

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[3] Note that 96-06 means 96 and 6/32.

Spread trading is inherently risky.[4] A good broker is a trader skilled at taking the types of risk described above. This very specialized trading skill is used by a dual trader to trade for his own account with the brokers for other customers who do not want the risks, or to trade for his own customers. A particular spread trader may go through periods where he has no customer business, but is able to support himself by trading for his own account. When his customers need him he is able to stop trading for his own account and provide them with spread brokerage services. The institution of dual trading thus puts more spread traders on the Exchange floor than would otherwise be present because it gives each trader more business in which he can earn a return from his skills, for the time he spends on the floor, and for the cost of his Exchange membership. It also permits the broker to use his risk bearing capacity to both cover the risk of trading on his own account as a market maker, and also the risk of being unable to fill customer limit and stop-loss orders.

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[4] A broker can avoid this risk by trading the spread directly with a local, however then the customer is indirectly paying someone else to bear the risk, and in effect using two people to execute the trade rather than one person.

Dual Trading and Liquidity on Futures Markets.

The above remarks indicate that customers will receive more skilled brokerage because of dual trading. However, there is an indirect benefit to customers from dual trading which they receive even if they use a broker who never dual trades. This benefit is the fact that dual trading will increase the number of market makers and especially spread market makers. The number of market makers is increased from dual trading for exactly the same reason that it increases the number of skilled brokers. The ability to engage in customer brokerage enhances the value of an Exchange membership to a market maker. The market maker knows that after he has committed as much of his own capital that he can to trading on his own account, then there is still another way to earn income from his presence on the trading floor, namely customer brokerage. This "second income" can be a substantial inducement to be a market maker, which significantly lowers the effective cost.

The fact that immediacy of trade execution is extremely important to futures customers implies that they will have a greater demand for market makers than will be the case in markets where the cost of delayed execution is smaller. A commodity hedger bears great risk if he does not do his futures trade immediately. This risk may force him to trade using a "market" order, for example to sell immediately to the highest bidder currently available. If there are few market makers then he will receive a relatively low price, i.e., his trade will have a high market impact cost. Thus futures markets have a great demand for market makers who accommodate immediacy of order execution. The institution of dual trading permits this demand to be met at low cost.

There is also great variability in the customer demand for both brokerage and market making services. The variability in price volatility which is common in futures markets creates both a great need for reserve brokerage capacity (as seen, for example, in the summer of 1988 where grain price volatility and trading volume rose after some slow years) and produces lulls during which it is hard for non-dual trading brokers to survive.

6. Preliminary Evaluation of Proposals to Restrict Dual Trading

A. Consequences of Eliminating Dual Trading

The fact that a broker trades for his own account and also trades for customers is a potential source of a conflict of interest. One major conflict of interest is that the broker may "front run" his customer order by trading on his own account before executing the customer's order. For example, a broker holding a large sell order for a customer might sell out of his own account first and thereby benefit from the price fall caused by the execution of the customer order. This potential abuse exists in both the securities markets and futures markets. It is a violation of NYSE rules for a member to trade ahead of its customer, and it is also a violation of CFTC regulations for a futures broker to trade ahead of its customer.

Though the elimination of dual trading may reduce the above conflict of interest, it will actually increase another type of conflict of interest. Front running is not the only source of conflict of interest between a broker and a customer. The broker gets paid for getting the trade executed. The customer wants an execution at a good price. The faster the broker can get the order executed, the sooner he can begin executing the next customer's order and earn another commission. The fact that a customer wants the broker to expend both time and effort to do the trade conflicts with the fact that the broker gets a commission on a particular trade independently of how hard he works the order. (Of course, the customer will not give repeat business to a broker who he knows provides him, with poor executions.) This conflict of interest is mitigated for a skilled broker/trader because it is easier for him to give his customer a good execution. It is also mitigated when there are many brokers (each, not overburdened with orders to be executed), and when a large supply of market makers are available giving good bids for large size orders.

Thus, the first consequence of eliminating dual trading will be to exacerbate the conflict of interest between a broker and his customer. We will show below that the elimination of dual trading will decrease the number of brokers, decrease the number of market makers, and decrease market liquidity. In times of heavy demand by customers for broker services, there will therefore be fewer brokers to handle the customer orders, and each order will be more difficult to execute because of the decrease in market liquidity. Since heavy demand by customers for brokers often occurs at the same time that market volatility rises, the elimination of dual trading will cause there to be: (a) fewer brokers to satisfy the increased demand for brokers, and (b) fewer locals trading as market makers to counteract the increased volatility. Broker/traders who are very skilled at trading will trade for their own account, while broker/traders who are somewhat less skilled will trade only for customers. In periods of heavy customer trading, these less skilled brokers will necessarily be under great pressure to quickly trade each order so that they can move on to the next order, thus maximizing their total commission.

The analysis presented in Section 6 showed that there are four main benefits associated with dual trading:

(1) Customers receive brokerage services from skilled traders.

(2) The number of brokers is increased.

(3) The number of market makers is increased.

(4) The liquidity of the market is increased.

In addition to exacerbating the conflict of interest between brokers and customers, the elimination of dual trading will clearly lower all of the above benefits.

The Best Traders Will Not Do Customer Trades

The best traders are those individuals who have a comparative advantage at judging short run market moves. If these individuals must choose between executing customer trades or their own trades exclusively, then they will choose to trade for themselves. The most that a broker can make from a customer trade is the commission. If he is a good trader for customers, then he will get more commission business, but he cannot share in the profit from individual trades. The most skilled traders will not give up the unlimited profit from buying low and selling high which they obtain from their own trading, in order to get commissions from customers. These trading profits are often high on the same days when there is high price volatility and thus high demand by customers for skilled brokers.

We noted in Section 5 that the facts that futures trading is focused on the Exchange floor and that futures customers often desire spread trades and trades characterized by great need for immediacy all combine to make a futures customer need relatively more skilled floor brokerage services than a securities customer. The elimination of dual trading from futures markets, while the maintenance of dual trading on securities markets would be eliminating the skilled floor brokers from the customers who have relatively the greatest need for their services.

The Number of Market Makers and of Brokers Will Decrease

The fact that an individual can engage in two activities to earn a return for the cost of an Exchange seat, the expenses of training, and the time spent on the Exchange floor will inevitably increase the supply of individuals who are broker/traders. Eliminating dual trading will lower the value of being on the floor for both activities. This is because an individual who now concentrates on being a broker can trade on his own account when his own brokerage business is light, and an individual who specializes in trading on his own account can switch to customer business when customers demand heavy brokerage services or when he has committed all of his capital to trading on his own account.

Dual trading creates a reserve group of potential brokers who can freely switch to customer business when the volume of customer orders rises. It also creates a reserve group of market makers who can add liquidity when customer orders threaten to have a large market impact.

Market Liquidity Will Be Reduced

The elimination of dual trading will reduce the risk capital made available by floor traders who act as market makers. This will increase bid ask spreads. It will decrease the liquidity provided in the periods when it is needed most, namely when there is an unanticipated inflow of customer orders. The inability of brokers to switch from customer business to trading for their own account will prevent them from taking the other side of the large inflow of orders. Therefore price movements will be exacerbated. Market prices will show greater volatility.

Spot Markets Will Be Adversely Affected

The decreased liquidity and increased volatility of futures prices will adversely effect the underlying spot markets. Futures markets serve a hedging and price discovery function which will be impaired by the elimination of dual trading. This will make holding the spot commodity or financial instrument more risky. This will impact on a whole range of underlying activities from grain storage to the financing of the US treasury debt.

One example of the type of impact can be seen in the grain market. Grain elevators buy grain and store it. They bear the risk that the price will fall between the time they buy the grain and the time they sell the grain. The elevator owner can hedge this risk by selling the grain forward on the futures market. He thereby shifts the risk to the rest of the world, rather than bearing it all by himself. The fact that the grain elevator does not have to bear the risk of price fluctuations means that it is able to pay farmers more for the grain. If the elevator owner had to bear the risk of price fluctuation, then he would pay the farmer less, so as to cover the risk he bears in storing the grain. If the liquidity of futures markets falls, or if transactions costs rise, then the effective cost of obtaining insurance from futures markets will rise. This increased cost will be passed along to farmers in the form of a lower price they receive for their grain. Final users of grain will not receive a lower price, but may even have to pay a higher price, since the grain elevator's effective cost of storing the grain has risen due to the increase in its cost of obtaining insurance in the futures market.

Another example of the deleterious effects of reducing futures market liquidity can be seen in the US treasury security market. Bond dealers who put in bids at US treasury auctions can hedge the inventory of bonds they acquire by using the US treasury bond futures market. The ability to hedge their inventory increases the amount that they are able to buy at auctions, and the price that they are willing to pay. If the cost of trading on the futures market rises, then this will increase the cost to the US treasury of issuing treasury securities.

The enormous importance of futures markets in our economy means that even small increases in the cost of using the markets or the liquidity provided by the markets can have very large impacts on the economy. If farmers receive $.05 less per bushel, or if consumers must pay $.05 more per bushel, or, if the US treasury receives 1/32 less per $100 of bonds it issues, then the consequences per 100 million bushels and per 1 trillion dollars of debt are enormous.

Foreign Markets Will Replace US Markets

The fact that dual trading is permitted in many foreign markets will give those markets an advantage over the US markets. The preeminence of many US futures markets arises from the great liquidity added by "locals", who are traders risking their own capital to add liquidity to markets. These locals will lose an important source of their potential income if they are excluded from customer brokerage, and hence be discouraged from entering the trading business.

The movement of brokerage business overseas will further decrease the liquidity of US markets because there will be fewer customers for a given customer on the US market to trade with. Customers forced to trade in the US will therefore be trading in less liquid markets, after mobile customers take their business elsewhere.

Customers Will Lose Their Freedom Of Choice

Currently, with dual trading permitted, a customer concerned about conflicts of interest can choose to use a floor broker who does not engage in dual trading. On the other hand, a customer who is not concerned about the conflict of interest and wants an active skilled trader can choose a floor broker who does engage in dual trading. This freedom of choice will be lost to customers if dual trading is banned.

B. Review of Proposals to Partially Eliminate Dual Trading

1. Eliminate Dual Trading in Liquid Contracts

There are two problems with this proposal. First, the contracts may be liquid exactly because of the ability of broker/traders to switch to market making activities when there is a large customer order which would otherwise have a large adverse price impact. It is very difficult to maintain a liquid futures market. Most contracts which have been introduced by Exchanges fail to become liquid and disappear. No customer will initiate a position when he fears that the market will not be liquid when he wants to take off the position. If customers lose confidence in the liquidity of a market, then that market will fail. A delicate balance is required for a market to survive, and anything which reduces the liquidity by even a small amount can initiate a vicious circle whereby customer confidence is lost, volume falls, so confidence further falls, and liquidity totally disappears.

A second problem with eliminating dual trading only from liquid contracts is the prevalence of spread trading between illiquid and liquid contracts. A typical spread trade will involve, for example, buying the near liquid expiration month, and selling a later less liquid month. It might even involve selling a less liquid commodity and buying a more liquid commodity. For example, a bond hedger may want to sell federal funds futures (a less liquid contract), and buy treasury bond futures (a more liquid contract), to hedge against a change in the term structure of interest rates.

In order for the spread market to be liquid a trader must be able to do both customer and principal business in both the liquid and illiquid contracts.

A third problem with eliminating dual trading in the liquid contracts is that the volume and liquidity of a particular contract can be quite variable. During periods of unusual weather, a grain futures contract that has had very little volume can show a huge increase in volume. If dual trading is banned from the contract when its volume of trade rises, then when there is a sudden rise in volume, there will be a shortage of brokers and traders to serve customer needs.

2. Eliminate Dual Trading at the Open and the Close of Trading

These are periods of the day with highest volume of trade. It is very easy for order imbalances (for example, a preponderance of customer sells over buys) to appear within a few seconds in this period as brokers attempt to execute "market on open" or "market on close" orders. The market making capital of a broker/trader can become crucial to maintaining price stability in the space of a few seconds. The benefits from switching from brokerage to principal trading can thus appear within a few seconds. This creates benefits from dual trading even at the open and the close of trade.

3. Limit the Size of Customer Orders Executable by a Dual Trader

This would lower the quality of brokerage services to large customers who often need it the most. It would increase price volatility, as large orders have higher market impacts due to execution by less skilled traders. The large traders are the most mobile, and will thus move their orders to foreign markets if they can be executed more effectively there. This will lower the liquidity available to the customers who remain. The customers who remain are likely to be small customers. Hence this limitation on dual trading will harm small customers more than it harms large customers.

4. Limit Dual Trading to the Back Months

I have already noted the problems with eliminating dual trading from liquid contracts. Eliminating dual trading from the front months will make spread trading very difficult, for reasons noted above. However it will also have another subtle, but deleterious effect. It will make it impossible for traders in the back month to hedge their risk in the back month contracts by taking an offsetting position in the front months. For example, a broker/trader who buys a back month contract like the December 1990 bond future (thereby providing liquidity to a customer who wants to sell it) would normally sell the front month to hedge his position. However, if he losses the ability to trade the front month, then he will cease to trade the back month because of the risk involved. Therefore eliminating dual trading from the front months will also cause dual trading to disappear from the back months.

7. Measuring the Benefits of Dual Trading

The previous Sections provide a theoretical overview of the economic role of dual trading and the nature of the benefits customers derive from dual trading. Much of the discussion in the previous Sections can be quantified. In particular, it is possible to measure the contribution made in various futures markets by dual traders. It should be noted that the measurement of the benefits is quite a complex process, and to the best of my knowledge no study exists which has measured the potential losses to the economy of eliminating dual trading.

An empirical analysis of dual trading must begin with an analysis of the extent to which dual trading exists in particular markets, particular contracts, and particular periods. No comprehensive analysis exists of the extent to which an individual member trades for his own account and also trades for customers. The trading records of individual members exist and can be used to reconstruct a record of overall dual trading. This data can be analyzed from two points of view. The first view is "positive", i.e., an attempt to determine what underlying factors have led to the observed historical patterns of dual trading. It would then be determined whether the observed patterns are consistent with the theory of dual trading outlined in the previous Sections. The second view is "normative". This approach will compute the extent to which dual traders have directly and indirectly benefited customers, and the extent to which these benefits would disappear if dual trading is prohibited.

The Determinants of Dual Trading

The theoretical framework developed in this report implies that the following factors will cause dual trading to be important.

1. The extent to which customers desire immediacy of execution. If there are large customer orders which must be "worked" (in the sense that trading it immediately "at market" will give the customer a poor price), but for which the customer bears great risk while the order is unfilled, then there will be a great demand for brokers who are skilled traders.

2. The extent to which customers desire complex spread trades. This is another example where the customer demands brokers with strong timing and bargaining skills.

3. The extent to which there is insufficient customer business or insufficient principal trading business for an individual to earn a living from engaging in only one of these activities.

4. The extent to which there are large swings in the demand for either brokerage or principal trades. Dual trading will be important when there are surprise increases or decreases in customer business which lead to wide and unpredictable variations in the appropriate use of a broker/traders time and effort.

The above factors can be quantified and used in a time series and cross sectional analysis of dual trading, to see if they indeed explain the degree to which dual trading occurs on various futures contracts in various periods.

The Benefits of Dual Trading

The factors emphasized in the previous Sections indicate that dual trading has a direct effect on customers via providing better floor brokerage services, and an indirect effect of increasing market liquidity.

Measuring the direct benefits of dual trading involves the following analysis.

1. Computing the extent to which direct brokerage costs are reduced, for a given level of broker quality, because a dual trader has multiple uses of his time, skills and Exchange seat, and thus can offer to trade at a lower cost.[5]
2. Measuring the extent to which customers receive better executions on complex spreads, and large orders through the use of dual traders.

Measuring the indirect benefits of dual trading on market liquidity involves the following analysis.

1. Computing the extent to which the effective bid ask spread is reduced due to the existence of dual trading.
2. Computing the extent to which the effective bid ask spread is reduced for spread trades.

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[5] "Measuring the Operational Cost of Dual Trading: An Analytical Framework", Kenneth L. Stanley, The Journal of Futures Markets, Vol. 1, No. 3, 329-336, 1981.

3. Computing the extent to which the market can absorb large orders to buy, or large orders to sell with a small market impact (i.e., market depth).

The measurement of effective bid ask spreads, and the measurement of market depth will be accomplished by various methods. All methods will rely upon the idea that trades which have a large market impact and/or are executed against wide bid ask spreads will cause price and expected returns to move in opposite directions. Recall that, for example, a seller will have a large market impact if the price can be expected to rise from the price at which his trade is executed. Various methods will be used to compute the extent to which price and expected returns are negatively correlated, including Roll's measure derived from the autocovariance of period by period returns), and the Grossman-Miller autocorrelation measure, as well as Kalman filtering approaches.[6]

It is important to control for other effects which may impact on actual market liquidity, these effects include variation across contracts in volume traded, average trade size, spot price volatility, time to expiration, the importance of intra-market and inter-market spread trading. Further, it is important to distinguish cause from effect. In particular, the magnitude of the above factors may be either a response to the increase in liquidity caused by the *supply* of dual traders or instead be factors which contributed to the *demand* for dual traders.

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[6] These approaches are summarized in : "Economic Costs and Benefits of the Proposed One-Minute Time Bracketing Regulations," Sanford J. Grossman and Merton Miller, *Journal of Futures Markets*, vol. 6, no. 1, 1986, 141-166. "Liquidity and Market Structure," Sanford J. Grossman and Merton Miller, *The Journal of Finance*, July 1988, Vol. 43, No. 3, 617-637. "Determinants of Liquidity Costs in Commodity Futures Markets," *Review of Futures Markets*, Spring 1988. "Inferring the Components of the Bid-Ask Spread: Theory and Empirical Tests," Hans Stoll, *Journal of Finance*, vol. 44, no. 1, March 1989.

Appendix

Dual Trading In Foreign Markets

In looking at financial markets throughout the world, one finds that dual trading is very prevalent. This is not surprising, given the important benefits that dual trading provides both to brokers and to clients. My preliminary review of world markets indicate that 15 out of 19 countries permit some form of dual trading. Dual trading can take the form of trader/brokers on the Exchange floor as in US futures markets, or the form of banks which act as both principals and agents for customers, or the form of designated specialists, or the form of broker/dealers who can trade on or off the Exchange floor with clients.

The following describes the structure of financial exchanges throughout the world, with regard to brokerage services and dual trading.[7] Unless specifically noted, the Exchanges described are stock exchanges.

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[7] This information was obtained from the following sources. International Society of Securities Administrators Handbook, 1986. European Stock Exchange Handbook, 1973, Noyes Data Corporation, Park Ridge, New Jersey. Major Stock Markets of Europe, Paul Stonham, 1982, St. Martin's Press, New York. The Principal Stock Exchanges of the World, David E. Spray, 1964, International Economic Publishers, Inc., Washington, D.C..

Australia

On the Sydney futures Exchange a local can trade for his own account as well as for other members of the Exchange. He is not permitted to trade ahead of his customer.

On the Australian stock exchange, stockbrokers may trade on their own account, as well as acting for clients. A broker dealer must disclose than he is acting as such. An odd lot specialist is a member broker who exercises a franchise to handle all odd lots. He is able to buy odd lots at a set rate of discount and sell at a set rate of premium, in order to be recompensed for his services.

Options are traded on the Australian options market in much the same manner as ordinary securities. A Registered Trader is required by the exchange to provide a continuous and orderly market by making a market in at least one contract when called upon to do so. He also maintains an appropriate price relationship among the options series in each stock he deals with. A floor trader is a representative of a member firm and executes client orders on behalf of his firm.

Austria

Those holding stock exchange cards include banks and other credit institutions, who may deal directly with each other in purchasing or selling securities. Official brokers may not engage in any stock exchange dealings on their own behalf. The securities quoted on the official list are divided up so that each official broker handles only certain securities. Brokers may also trade off the exchange. Free brokers, who are not officially appointed by the exchange, act as intermediaries between credit institutions, or between clients and credit institutions. They may also trade on their own behalf. Free brokers also deal in securities which may be traded on the exchange floor but which are not officially quoted. All securities may be traded off the exchange.

Belgium

Trading is done exclusively by brokers ("Agents de Change"). These brokers are forbidden to act as a principal. The brokers can receive orders directly from clients or indirectly from corresponding brokers or banks. Corresponding brokers receive orders from clients which they must bring to the brokers for execution. Banks must also go through the brokers to get trades executed, except for orders of over Bfr. 10 million.

Corresponding brokers and banks may act as both agent or principal.

Brazil

Brokerage firms cannot trade for their own account or act as principals. By contrast, investment banks and distribution companies may trade for their own account.

Canada

Member firm brokers trade for their customers and retain a commission as payment. Securities firms who wish to trade listed securities without formally joining the exchange may do so as an authorized non-member. A Registered Trader acts as a dealer in specific stocks assigned to him by the exchange. His function is to act as a market maker in those stocks - to contribute to market liquidity and enhance price continuity. The Registered Trader can execute trades as an agent for a member firm and may also trade his own account, within limitations.

Finland

Most members are banks. Members may trade for their own account as well as for clients. Banks are major investors as well as brokers.

Germany

Clients must place their orders through a bank which is represented on the stock exchange. Banks may trade securities for their own account, take the other side of a customer position, or arrange for another bank to take the other side. They may also place trades through a broker. Official brokers are assigned certain securities by the exchange. Their function is to arrange transactions and set official quotations. The official broker sets a single price for each security which permits him to execute the largest number of orders received for that security. If additional orders are needed to balance existing orders, he calls the quotations to receive them. He may then enter into the trading himself so far as it is necessary to fill existing orders. Otherwise, official brokers are not supposed to deal in their assigned securities for their own account. "Free brokers" execute transactions between banks and may also trade for their own account.

France

Member firms of MATIF, the French financial futures Exchange, are able to execute both proprietary and customer orders.

Securities clients may place orders through a bank or a remisier, an investment advisor. The banks and remisiers in turn transmit the orders to a broker who executes them on the floor or off the exchange. A broker may not trade for his own account or acquire any interest in or any management responsibility for any commercial or industrial enterprise other than his brokerage firm. Banks may also deal directly, off the exchange, including trading on their own account and taking the other side of a customer order.

Hong Kong

All orders must be executed by stock exchange brokers or their employees. Brokers may also trade on their own accounts, as long as these transactions are segregated from those for their clients. Brokers may employ authorized clerks or sales representatives to execute orders on the floor. These employees may not trade for their own accounts.

The Hong Kong Futures Exchange permits dual trading.

India

Any member can act as both a principal or an agent, as long as he provides notification that he is trading for his own account.

Italy

Banks may receive client orders and match them, but all trades executed on the exchange must be done by brokers. The brokers may not trade on their own account nor own any interest or accept any managerial responsibility in any commercial or industrial firm other than their own brokerage firm.

Japan

Regular members of the exchange are companies who both receive orders from clients and trade on their own account. Most regular members also underwrite securities. Special members perform the function of connecting markets by handling orders at the Tokyo or Osaka exchanges which could not be filled on the regional exchanges. Except in situations of unusually high volume, stock exchange members must send orders to the saitoris for execution. These are companies who are responsible for matching orders and fixing the price for those stocks assigned to them by the Exchange. Saitoris cannot trade for their own accounts in the stocks to which they are assigned.

Luxembourg

Stock exchange members are banks or stockbrokerage firms. Stockbrokerage firms may execute trades on their own account as well as for clients. Banks and brokers may trade directly between themselves, without intermediaries. Banks may take the other side of a customer trade.

Mexico

Members are either individual brokers or member firms. Individual brokers may trade for their own account or for a member firm. Brokerage firms may execute orders for clients or trade for their own account.

Netherlands

Banks and brokers receive orders from clients. All orders are transmitted to a hoekman, or specialist. The specialists execute trades in a particular set of securities. They receive a commission form the banks and brokers for performing this function. They may also trade for their own account.

The European Options Exchange is an association set up under Dutch law. Members include banks, brokers, and private traders from North America, Canada, Western Europe and the Far East. Public order members receive orders from the public and pass them to a floor broker for execution. Market makers are traders who are responsible for making a market in those options assigned to them. They act exclusively for their own account.

Singapore

There are three kinds of stock exchange dealer. A stockbroker is a shareholder in a member firm. He may act both for clients and for his own account. A dealer is an employee of a member firm. A remisier is a commissioned agent of a member firm. He may only transact business on behalf of the firm he is employed by.

Trades can also be carried out off the floor and outside of normal hours.

The Singapore International Monetary Exchange is a futures market which permits dual trading by floor broker/traders.

South Africa

Stockbrokers primarily trade for clients, but may also trade on their own account. A "dealer in stocks and shares" primarily trades for his own account, but may also hold himself out to the public. Trading also takes place off the exchange, typically directly between institutional investors, such as banks or insurance companies.

Spain

Orders may be placed through banks or directly with a stockbroker. All orders must be executed by a stockbroker. Stockbrokers may not trade for their own account.

Switzerland

Banks are the only members of the stock exchange. Member banks may trade either on or off the floor. Off the floor trading permits banks to match customer orders against each other. Banks may trade for clients and also trade directly with each other as principals. Formally, most orders are executed by the banks acting as principals.

United Kingdom

The London International Financial Futures Exchange permits dual trading. In particular, Public Order Members are permitted to trade for their own accounts, as well as for customers.

The new securities "market" is based on a system of broker-dealers functioning in a dual capacity, trading as agents for clients as well as principals on their own account. Broker-dealers may also take the other side of a customer order. Certain broker-dealers act as market makers in specific securities. They may deal directly with investing clients. Inter-dealer brokers provide a mechanism through which market makers can trade anonymously with each other. Inter-dealer brokers are not allowed to take positions in stocks. Some market makers are located off the floor in their own trading rooms and trades may be executed by telephone.

United States

The New York Stock Exchange (NYSE) permits the designated specialist to trade as a broker's broker and also to trade for its own account. NYSE broker/dealers can trade for their own account on the NYSE floor as well as for their customers, but they cannot trade ahead of their customers. Other Stock Exchanges have similar rules.

The Chicago Board Options Exchange requires floor traders to choose whether on a given day they will execute customer business exclusively or trade for their own account exclusively. Broker/dealers who are members have employees on the floor who may trade for their firm's account or for customers.

All major futures Exchanges permit dual trading.

(Attachment is held in the committee files.)

Statement of

Warren Lebeck

Representing the National Grain Trade Council

Mr. Chairman and Members of the Subcommittee:

My name is Warren Lebeck and I appear before you today representing the National Grain Trade Council. I am the immediate past chairman of the Council and serve on the organization's Executive Committee. On behalf of the 63 member organizations and companies of the Council, I wish to thank you for the opportunity to share our views with you on H.R. 2869, the "Commodity Futures Improvements Act of 1989."

The National Grain Trade Council is a trade association founded more than a half century ago. Its objectives were straightforward then, and remain its purpose today:

1. To promote better understanding among the grain trade, government agencies, and the public generally; and

2. To advocate and defend, consistent with public interest, the principles and merits of open and competitive markets for the distribution of agricultural commodities.

Council members cover the full spectrum of the agribusiness infrastructure. Our members include firms who handle bulk grains, transportation firms, companies that process agricultural products into consumer-ready items we purchase on the grocery shelf, cash markets where grain is bought and sold, and futures markets where the price risks associated with merchandising grain are hedged.

Futures markets and the grain trade grew up side-by-side in the United States economy. Since the middle of the last century, the grain industry has relied on futures markets to hedge market risks; and futures markets have fulfilled that purpose in an open and efficient manner. American consumers are thus deep into their second century of enjoying the wide-ranging benefits of price efficiency created by this economic relationship.

It is economically true that markets work best when two conditions are met: (1) the widest possible number of bids and offers are available in any given market, and (2) that same market is free from artificial restraints and influences that affect price discovery.

Maximum liquidity means free and open access to the market by the widest possible spectrum of buyers and sellers who have individual independent opinions about the price of a given commodity. The more bids and offers in a market, the better will be the price discovered in it; and the more bids and offers in a market, the more reliable getting in and out of it becomes for those who need to use it.

Abusive trading practices can rob futures markets of their efficiency. In their own self-interest, all markets guard against them.

As in any endeavor where people are involved, unfortunately there are always those who are tempted to finds ways to gain an unfair advantage. Consequently, futures markets must constantly remain vigilant in their surveillance and market protection efforts.

The National Grain Trade Council, therefore, supports positive improvements to prevent and detect abuses. We strongly support most elements of H.R. 2869 and we certainly endorse the intent of the legislation.

1. Permanent reauthorization of the Commodity Futures Trading Commission (CFTC): We strongly support permanent legislative status for the CFTC. To the extent any question remains, this provision would remove all uncertainty about the permanence of a specifically focused federal regulator of U.S. futures markets. It would also ease the extraordinary drain of limited regulatory resources which are now diverted every three or four years from regulating to rejustifying their authority.

2. Floor trader registration: We strongly support registration of floor traders. This is the last group of industry professionals outside the traditional requirements of FBI fingerprint and background checks, and a good set of statutory fitness qualifications.

3. Ethics training: We strongly support the proposed ethics training requirements for those registered under the Commodity Exchange Act. As mentioned earlier, one of the Council's objectives is to promote better understanding of grain marketing by the public. Futures markets are a very complex and often misunderstood part of grain marketing. For this reason, we believe it is important for the public to perceive that futures market participants are subject to such training and standards.

4. Membership on exchange boards: For similar reasons, we strongly support the emphasis H.R. 2869 would place on having public directors on exchange governing boards. We would note the major grain exchanges already have significant public representation on their governing boards. The Council likewise applauds the provision which would prohibit exchange members found guilty of rule violations considered "major" by an exchange from serving on such boards or exchange committees.

The National Grain Trade Council believes the two most critical elements of the bill, however, are the audit trail and dual trading provisions. The Council believes these two areas contain the bill's best and worst features.

The best feature of H.R. 2869 is its emphasis on improving exchange audit trails. The best way to curtail potential trading abuses is to have audit trails that will effectively catch rule breakers. The test is not whether the systems meet some arbitrary time or other standard. The test is whether the systems work. Will they catch violators with such predictability that they have a deterrent effect as well?

The members of the Council recognize there is no such thing as a 100 percent accurate and verifiable audit trail. We are heartened for at least two reasons that H.R. 2869 would not try to establish such a standard. First, it is clearly a complex issue. Thus we believe regulatory specifics should be established by the Agency subject to Congressional oversight. We believe the best audit trail is not one which meets a particular time standard. The best audit trail is one which would deter people from the temptation to violate the rules.

The National Grain Trade Council endorses all practical efforts to reach that goal. We urge the Congress to exercise its oversight role vigorously to ensure the CFTC will push hard toward that end: audit trails that scare off would-be rule violators without harming the markets and customers and traders they are designed to protect.

The rule violation issue brings me to the Council's final comment on H.R. 2869 -- dual trading. The bill proposes to limit dual trading to address the possibility of abuse by brokers trading ahead of their customers. This practice, however, can be best prevented through a tough audit trail.

Applying any ban to the more actively traded contracts would most significantly threaten the liquidity in deferred months of those contracts. Dual trading contributes importantly as an adjunct source of market liquidity in those back months, allowing commercial users to hedge future sales. Commercial users are still feeling the impact of reduced liquidity in deferred months which occurred following Congressional action in the early 1980's to require that all futures positions be marked-to-market for tax purposes at the end of each year. A move that would limit dual trading would further damage the already fragile liquidity in those deferred months.

In addition to harming market liquidity, a ban on dual trading could cause the more successful broker/traders to choose not to handle customer accounts. As a practical matter, this could leave public customer orders in the hands of less efficient brokers, which would result in worse, not better, fills for these orders.

Mr. Chairman, the Council feels so strongly about this issue because as commercial users of futures markets, our members do not have the luxury of being able to stay out of the futures markets. We must be and we are buyers and sellers of futures contracts during every minute the futures markets are open. The economic benefit of additional liquidity is difficult to measure, but it is real and cannot be refuted. Section 101 would force the unknown cost of doing without it onto the commercial users of the markets. This would raise costs not only for market users, but for all that produce, use, or consume grain, in short -- all of us. It seems clear to us that the cost of this supposed remedy greatly exceeds any perceived benefits.

Conclusion

The efficiency of our futures markets must be preserved and enhanced, Mr. Chairman. As I have said, the National Grain Trade Council believes H.R. 2869, with one exception, would do just that. The answer to eradicating possible trade practice abuses is through detection and deterrence.

The Council urges you to keep an eye toward what greater contributions American futures markets can provide our country. This very Committee continues to grapple with the issues of price risks in the production of U.S. commodities. As production decisions continue to move toward market-driven from government-driven, the classic risk-shifting functions of futures markets will become increasingly attractive to producers, themselves.

Accordingly, Mr. Chairman, I wish to close by complimenting again the emphasis H.R. 2869 would place on audit trail enhancement. The National Grain Trade Council strongly urges the Subcommittee to give the CFTC and the exchanges all possible support to that end.

Thank you.

JOHN L. FREDRICKSON
KENTLAND ELEVATOR & SUPPLY, INC.
KENTLAND, INDIANA

CHAIRMAN ENGLISH AND MEMBERS OF THE COMMITTEE:

MY NAME IS JOHN L. FREDRICKSON. I AM A PARTNER IN KENTLAND ELEVATOR & SUPPLY, INC., A COUNTRY ELEVATOR LOCATED IN NORTHWEST INDIANA. I HAVE BEEN INVOLVED IN THE MANAGEMENT OF GRAIN ELEVATORS FOR OVER TWENTY YEARS. I ALSO OWN AND OPERATE A SMALL FARM, SERVE AS AN OFFICER OF OUR STATE GRAIN AND FEED ASSOCIATION, AND SERVE AS DIRECTOR OF AN INSURANCE COMPANY.

THE FIRM I REPRESENT IS AN INDEPENDENTLY OWNED COUNTRY GRAIN ELEVATOR WITH THREE LOCATIONS. THE PRIMARY BUSINESS OF OUR COUNTRY ELEVATOR IS PURCHASING GRAIN FROM AREA FARMERS AND RESELLING IT TO GRAIN PROCESSORS, GRAIN EXPORTERS AND LIVESTOCK AND POULTRY FEEDERS.

WHEN WE PURCHASE GRAIN FROM A FARMER, WE ARE AT RISK IN THE MARKET UNTIL WE HAVE SOLD THE GRAIN. WE MAY CHOOSE TO SELL THE GRAIN TO A USER FOR IMMEDIATE DELIVERY, OR WE MAY CHOOSE TO KEEP THE GRAIN IN ONE OF OUR STORAGE FACILITIES TO SELL AT A LATER TIME. IF WE CHOOSE TO STORE THE GRAIN, WE MUST TRANSFER THE MARKET RISK TO SOMEONE ELSE IMMEDIATELY. THIS IS ACCOMPLISHED BY HEDGING THE GRAIN IN THE FUTURES MARKET AT THE CHICAGO BOARD OF TRADE. WE PLACE AN ORDER TO SELL FUTURES CONTRACTS FOR THE AMOUNT OF GRAIN WE HAVE PURCHASED. WHEN WE DECIDE IT IS NO LONGER ECONOMICALLY FEASIBLE TO HOLD THE GRAIN, THE FUTURES PORTION OF THIS TRANSACTION IS OFFSET BY BUYING FUTURES CONTRACTS AT THE SAME TIME THE CASH GRAIN IS SOLD. OUR ELEVATOR'S MARGIN IS THE SELLING BASIS, LESS THE BUYING BASIS.

THE EXECUTION OF THE FUTURES ORDERS IS A CRITICAL COMPONENT OF THE TRANSACTION, AND MUST BE COMPLETED AT THE BEST POSSIBLE PRICE AND EXECUTED PROMPTLY. THE LIQUIDITY AND FLEXIBILITY PROVIDED BY DUAL TRADERS WHO CAN TRADE FOR THEIR OWN ACCOUNT AS WELL AS EXECUTE CUSTOMER ORDERS, IS A CONTRIBUTING FACTOR FOR OUR COUNTRY ELEVATOR TO OBTAIN THE BEST PRICE AT THE LOWEST COST.

SOMETIMES WE MAY DETERMINE THAT IT IS NOT ECONOMIC TO SELL THE CASH GRAIN AS THE FUTURES EXPIRATION APPROACHES AND DECIDE TO "ROLL" THE HEDGE FORWARD TO A DEFERRED CONTRACT MONTH. THIS TRANSACTION IS CALLED A SPREAD SINCE IT INVOLVES THE SIMULTANEOUS PURCHASE AND SALE OF FUTURES CONTRACTS IN DIFFERENT MONTHS. SUCCESSFUL EXECUTION OF A SPREAD TRADE IS OBTAINED BY UTILIZING AN EXPERIENCED DUAL TRADER WHO CAN "LEG" INTO THE POSITION BY EXECUTING ONE SIDE OF THE TRADE WHEN PRICES FOR THAT CONTRACT ARE MOST FAVORABLE. HE MAY NOT BE ABLE TO OBTAIN THE DESIRED PRICE FOR THE OTHER LEG OF THE TRADE, BUT MAY PLACE IT IN HIS OWN ACCOUNT AT A SLIGHT LOSS IN ORDER TO SATISFY THE CUSTOMER AND KEEP HIS BUSINESS. THE ABILITY OF THE DUAL TRADER TO OBTAIN FAVORABLE PRICES FOR SPREAD TRADES HELPS INCREASE THE LIQUIDITY IN RELATIVELY LESS ACTIVE DEFERRED CONTRACTS, AND RESULTS IN MORE ACCURATE INDICATIONS TO MARKET PARTICIPANTS OF THE COST OF CARRYING COMMODITIES.

THE BANNING OF DUAL TRADING COULD INCREASE TRANSACTION COSTS FOR OUR ELEVATOR BY WIDENING BIDS AND OFFERS DUE TO LESS PIT PARTICIPATION. THIS INCREASED COST WILL CAUSE EITHER A REDUCTION IN OUR RETURN ON INVESTMENT, OR A REDUCTION IN PRICES PAID TO FARMERS BY OUR FIRM.

DUAL TRADING INCREASES THE SUPPLY OF BOTH BROKERS AND FLOOR TRADERS BECAUSE A DUAL TRADER CAN EARN INCOME FROM TWO SOURCES TO COVER THE COST OF TRAINING, AN EXCHANGE SEAT AND TIME SPENT ON THE FLOOR. DUAL TRADING ENCOURAGES GREATER COMPETITION BETWEEN BROKERS, THUS KEEPING COMMISSION CHARGES DOWN. IF DUAL TRADING IS BANNED, THE BEST BROKERS WILL TRADE FOR THEIR OWN ACCOUNT, DECREASING THE NUMBER OF BROKERS AVAILABLE TO EXECUTE ORDERS FOR OUR ELEVATOR. THIS WILL REDUCE THE LIQUIDITY OF THE MARKETPLACE, THUS MAKING IT MORE DIFFICULT TO HAVE OUR ORDERS EXECUTED PROMPTLY AT THE MARKET.

DUAL TRADING IS VOLUNTARY ON THE PART OF CUSTOMERS; CUSTOMERS CAN NOW PROHIBIT THEIR BROKERS FROM DUAL TRADING IF THEY CHOOSE. ADDITIONALLY, U.S. FUTURES EXCHANGES ARE ENGAGED IN A CONTINUING PROCESS OF IMPROVING THEIR MARKET SURVEILLANCE SYSTEMS. IF ABUSES CAN BE CURBED THROUGH ADEQUATE SURVEILLANCE, THERE IS NO REASON TO ELIMINATE A PRACTICE LIKE DUAL TRADING WHICH CONTRIBUTES TO THE LIQUIDITY FOR WHICH AMERICAN MARKETS ARE KNOWN.

SIMPLY STATED, THE IDEAL LEGISLATION WOULD PRESERVE DUAL TRADING WHILE INSURING THE EXCHANGES BEAR THE RESPONSIBILITY FOR DETECTING ITS POSSIBLE ABUSE.

I STRONGLY URGE CONGRESS TO EVALUATE THE PROS AND CONS OF DUAL TRADING BEFORE MAKING A FINAL DECISION ON THIS VITAL ISSUE. YOUR DECISION WILL EFFECT THE ENTIRE AGRICULTURAL INDUSTRY, AS WELL AS THE FUTURE OF OUR MARKETS.

DAVE DANKER
BUCHHEIT GRAIN, INC.
PERRYVILLE, MO 63775

Chairman English and members of the Committee, my name is Dave Danker and I am the Vice President and General Manager of Buchheit Grain, Inc., located in Perryville, Missouri. Buchheit Grain is part of a small, family-owned feed, grain and general merchandise business founded in 1934.

My purpose in coming here to speak to you today is to attempt to explain how we use the futures markets, in particular the spread market, to effectively manage our business and how that relates to one of the subjects your Committee is reviewing, _i.e._, dual trading. We have approximately 1,250,000 bushels of space in two different locations. In order to survive as a grain merchant, we must fill all of our space at harvest and hopefully handle 60-70% of that volume once again after harvest. In order to manage this need in a business-like manner, it is imperative that we pre-spread our space and the volume of grain that we hope to handle post-harvest. A brief example of pre-spreading would be the simultaneous purchasing of 10,000 bushels of December Corn futures while selling 10,000 bushels of March Corn futures. As the corn is purchased from farmers during October, we simply sell December Corn futures. This automatically spreads the purchase out to the March futures position.

Pre-spreading is an inexact science, but as one gains experience, it becomes easier to establish reasonable goals and achieve them. We like to enter our spread orders prior to the time the contract actually trades. Oftentimes this results in getting a good fill that may never be available at any other time during the marketing cycle. Quite often, due to poor liquidity in those distant contract months, our broker has to "leg" a spread in order to get it filled. By legging the spread, the broker first takes one side of the spread, then fills the other side as soon as he is able.

During the time elapsed between the execution of both legs of the spread, the broker assumes the risk of not getting the spread filled at or above my order. If he fails to accomplish that fill and ends up trading the spread at a lesser amount, the loss is for his account. A broker's ability to dual trade gives him an opportunity to offset these losses by trading for his own account throughout the day. I feel that this makes spread brokers more willing to take chances in order to get their customers the best possible fill, thereby maintaining their reputation and position in the marketplace.

I had a personal experience with this situation last winter that I would like to share with you. Last January, I began planning for the 1989-90 marketing year. I budgeted the purchase of 200,000 bushels of soybeans at harvest. I estimated that we could buy at harvest, store and later resell soybeans if we could get our November/March spreads set at 17 cents/bushel or better. I called my trading firm and entered an order to spread 200 November/March soybeans at 17 cents or better. A few days after the March '90 soybean contract came on the board, my spread got filled at 19 cents/bushel. Given what I know about spread conditions at that time, I have to assume that the trade was legged by the broker.

Now, I realize that not all trades will have such a happy ending, but I believe that it illustrates my point that if you trade through a brokerage firm that does the job in policing and controlling the trading activities of the brokers that it uses, you can get good honest fills. It seems to me that if a customer is knowledgeable about the current conditions of the market, offers spreads, options and futures transactions at a given level or better, he will obtain the fill he wants.

The key to obtaining these fills is in prior evaluation of the quality of broker that you choose to deal with and in the existence of surveillance systems that detect and deter abuse. The issue is not whether the broker dual trades. The real issue is whether or not there are adequate monitoring systems in place to detect cases where the practice of dual trading is abused.

In summary, I would like to stress that I feel the current system of allowing brokers to both fill orders and take risks for their own account, provides a more liquid market and, most probably, a more aggressive trader. The system, as it exists, has provided us with the structure to build a successful small business. I would like to encourage you to provide a means for protecting and improving the integrity of the current system of dual trading rather than changing something that, in my opinion, already works.

Remarks of Joseph J. Kane, Floor Broker, Before the Subcommittee on Conservation, Credit and Rural Development of the House Agriculture Committee

July 20, 1989

Chairman English and Members of the Committee:

Thank you for letting me appear before you today. My name is Joseph J. Kane. I am a member of the Chicago Board of Trade and have been a floor broker since 1952. I have also been a member of numerous other exchanges including the Chicago Mercantile Exchange and the New York Coffee, Sugar & Cocoa Exchange. For seven years, I was a director of the Chicago Board of Trade and have served on most of the Exchange's major committees including the Business Conduct and Floor Governors Committees. In fact, in 1968, I was chairman of the Reorganization Committee that was responsible for introducing public members to our Board of Directors and for creating the Floor Governors Committee which has primary responsibility for policing the conduct of our members on the Exchange floor. I was born, raised and educated in Chicago and am the father of eight children. Many of my children have worked in one capacity or another in the futures business.

I have been at the Chicago Board of Trade long enough that I can say I knew the grandfathers of two of our present members of the Board of Directors. I know the Board of Trade's rules, customs and practices. I have seen those rules, customs and practices evolve. I have also seen the competition for business which exists on the floor and the solid ethical standards upheld by most members combine as a potent force for the protection of customers.

Nevertheless, I know this Subcommittee is concerned about the practice of dual trading. I believe I am in a good position to discuss this practice and the rules which govern this practice because, throughout my thirty-seven years as a floor broker, I have also routinely traded for my own account. Over the years, I have given a lot of thought to the subject of dual trading. In 1975, I was co-author of a study on that topic which formed a part of the Report of the Chairman of the Advisory Committee on the Regulation of Contract Markets and Self Regulatory Associations of which I was a member which was submitted to the CFTC that year.

In that report, we came to the conclusion that dual trading was a major ingredient in the liquidity of our markets and that its elimination would impair that liquidity without conferring any measurable benefits on the public. We recommended that dual trading be preserved but that rules be adopted which clearly prohibit a broker buying or selling for his own account while holding orders for others at the market or at the same price. We also recommended that surveillance systems be improved so that the exchanges in conjunction with the CFTC could ensure that abuses of that and other practices were detected and punished.

I believe our recommendations were valid then and that the last 14 years have vividly demonstrated their validity. In the intervening years, our markets have enjoyed an unprecedented growth in volume and liquidity, making them the envy of the world. At the same time, the Chicago Board of Trade and other exchanges adopted straightforward rules to make the misuse of dual trading, i.e., trading ahead of a customer order, a trade practice violation.

And, most important of all, over the last ten years and, in particular, the last five years, the exchanges have taken strides, unimaginable in 1975, to create and implement effective surveillance systems for detecting all trading abuses, including trading ahead. In particular, the computerized audit trail co-designed by the Chicago Board of Trade and the Chicago Mercantile Exchange has demonstrated a detection and deterrence capability offered by no other financial market in the world. At least that was the view expressed by Nicholas Brady as head of the Presidential Task Force which studied the 1987 stock market crash.

I don't pretend to speak for the entire floor broker community in coming here today. But I know if I conducted a survey of the many, many responsible floor brokers with whom I work each day, they would want to stress for you the following points. First, they would tell you that you would take away a major means of servicing their customers if you take away dual trading. Dual trading allows a floor broker to go after the best fill for his customer knowing the broker has the flexibility, if necessary, to trade out of resultant losing positions through his personal account whenever the opportunity arises. Second, they would tell you they support the adoption of the best, most comprehensive surveillance system devisable as a means of protecting themselves as well as their customers.

The message I would leave with you is simple. We have the best, most liquid markets in the world. I am not an economist, but I believe a rational review of the economic literature available on the subject will lead to the conclusion that dual trading has contributed to the unrivaled success of our markets. In copying every aspect of our market formula in an effort to win business from us, foreign markets have also copied us in permitting dual trading. But foreign markets do not have our surveillance capability. They don't have the know-how and they don't have the commitment to eliminate trading abuses and the perception that such abuses exist. Let us use our know-how and our commitment to keep U.S. markets in their preeminent position. With your help, we can preserve our liquidity, and all the factors that contribute to it, including dual trading, while reinforcing the integrity for which we must equally be known.

Logan County
Farm Enterprises, Inc.

Business Office
1923 So. Division
Guthrie, OK 73044
(405) 282-3901

Elevator
500 W. Vilas
Guthrie, OK 73044
(405) 282-3900

July 10, 1989

Honorable Glenn English
Chairman,
Ag Sub Committee for Conservations, Credits & Rural Development
1301 Longworth Office Building
Washington, DC 20515

Dear Congressman English:

It has been brought to my attention that a bill has been presented to eliminate dual trading in futures contracts that have over 7,000 contracts traded per day. Being in the grain business, I have a real concern that eliminating the dual trading process will hurt the effectiveness and ability of the futures market to function efficiently.

I would like for your sub committee to investigate working with the exchange and the regulators to police abuses at the exchange's level rather than changing the way trading has been handled in years past.

I feel strongly that the system has worked in the past and, hopefully, the abuses can be rectified through the exchanges. It seems to me that the system works and all that needs to be done is to weed out the bad apples.

I hope that you will investigate all sides of the situation before taking drastic action such as banning dual trading.

Sincerely,

LOGAN COUNTY FARM ENTERPRISES

Linn Cheatham
Vice President

LC:ct

Farm Enterprises *Garrison Milling* *Caddo Grain* *Carnegie Grain* *Mid America Grain*

M&M MARS

a division of Mars, Incorporated

High Street, Hackettstown, New Jersey 07840/Telephone 201 - 852-1000

11 July 1989

Congressman Glenn English
2206 Rayburn House Office Building
Washington, D.C. 20515-3606

Dear Congressman English:

I am writing with regard to the legislation you and Congressman Coleman proposed that would restrict dual trading in certain futures markets.

Our firm uses sugar futures extensively to hedge its price risks. It is important that the markets we use for the purpose are sufficiently liquid to assure the best available prices. Poor trade executions resulting from loss of liquidity will result in increase costs of operations, which will be passed on to consumers.

We are concerned that the proposed restrictions on dual trading in these markets could hurt their liquidity. We, therefore, urge that no restrictions be adopted unless and until the potential impact on the markets has been thoroughly studied and assessed.

Very truly yours,

Gerald P Clancy

Gerald P. Clancy
Cocoa Purchasing Director

a:congrltr.doc

New York Cotton Exchange
Four World Trade Center
New York, New York 10048
Executive Offices

July 26, 1989

Hon. Glenn English, Chairman
House Agricultural Subcommittee on
 Conservation, Credit and Rural Development
Room 1301, Longworth House Office Building
Washington, D.C. 20515

Re: HR 2869 The Commodity Futures Improvement Act of 1989

Dear Chairman English:

The New York Cotton Exchange ("NYCE®") appreciates this opportunity to submit its comments on HR 2869.

Founded in 1870, NYCE® is the oldest commodity exchange in New York and takes great pride in its 120 years of service to the cotton trade and to the public. Hence, we are particularly grateful for your concern and interest in the integrity and efficiency of the commodity futures markets in the United States.

We recognize and applaud your efforts in developing and introducing HR 2869 and offer the following comments regarding its major provisions:

(1) Dual Trading

We believe that dual trading should continue to be allowed with appropriate emphasis on accurate audit trails and rigorous enforcement of exchange rules.

The American Cotton Shippers Association and other cotton trade groups support the NYCE® on this position.

(2) Audit Trails

We are satisfied that our present system of capturing the minute-by-minute execution time is effective. We are concerned that the proposed "30 second rule" would result in increased inaccuracies.

The Exchange will continue vigorous enforcement of its audit trail rules and is prepared to take prompt action against any member whose performance impairs the effectiveness of our audit trail.

The CFTC is to be applauded for not mandating one system for all exchanges. Rather, the CFTC has followed a performance standard which allows each exchange to have its own mechanism. Consequently, the shared goal should not be to mandate one audit trail system, but rather the fostering of accurate and effective audit trails on each of our markets.

(3) Three-Day Cooling Off Period

The Exchange recognizes that this is an area concerning which our FCM community has the expertise and it defers to their consideration on this matter.

(4) Broker Associations

To the extent that a broker association attempts to enable brokers to do indirectly what they cannot do directly and that action is contrary to the customer's best interests, that broker association should be prohibited from doing so. We do not believe a static number (e.g. 25%) is the appropriate way to deal with this. Rather, we believe that audit trail records and trade practice surveillance programs need to be sufficiently sophisticated to isolate those activities. Thereafter, prompt and effective disciplinary action should be taken to root out such prohibited activities.

(5) Permanent Re-authorization

We agree that the CFTC should become a permanent agency.

(6) Undercover Surveillance

We believe that the overt surveillance that already takes place in the exchange community is thorough and productive. We do not believe there is any legislative need or purpose served by singling out any industry, whether it be the banking industry, defense contractors, health care, or any other industry, for federal undercover operations. Those, we presume, take place when and as the appropriate law-enforcement agencies so determine.

(7) Governing Boards

As an Exchange which has had public board member representation for more than a decade, we support the concept of public membership but do not subscribe to a rigorous percentage (20%) such as that found in the proposed bill.

On the subject of barring certain rule violators from service on governing boards for a period of years, we endorse and foster that concept. However, experience shows that one exchange's categorization of a violation may be different from another's, even though they use the same or different labels. Prohibition from governing boards for a three-year period as a penalty for a rule violation should be handled on a case-by-case basis by each exchange for serious violations, irrespective of the rubric or rule number under which the person is prosecuted or concerning which he makes an offer of settlement.

(8) Make-up of Disciplinary Committees

We believe disciplinary committees should be expert and reach fair and prompt decisions. We believe that a system of categorization of participants on disciplinary panels is valuable only to the extent that it does not interfere with those goals.

(9) Registration

The Exchange sees no problem with all trading members going through the CFTC registration process, including those who only trade for themselves.

(10) Ethics

This Exchange joined with other New York exchanges in inaugurating a cooperative ethics course. Our Board approved that concept in December of 1988 and we are pleased with the manner in which it is being conducted.

(11) Commission Proposals

The Exchange believes that the Commission proposals are proper and has no further comments with respect to them.

I have asked the President of the Exchange, Joseph J. O'Neill, and our Washington representative, Wes McAden, to be available to the Subcommittee and its staff with respect to any questions that may arise as the legislation proceeds. I, of course, will be glad to help in that effort.

Very truly yours,

Donald B. Conlin
Chairman of the Board

DBC:cm

cc: Members of the House Agricultural Subcommittee on Conservation, Credit and Rural Development

DYER SERVICE SINCE 1903

B.W. DYER & COMPANY

ECONOMISTS & BROKERS IN SWEETENERS & FUTURES

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MEMBERS:
COFFEE, SUGAR & COCOA EXCHANGE, INC.
CSC CLEARING CORPORATION
NATIONAL SUGAR BROKERS ASSOCIATION
NATIONAL FUTURES ASSOCIATION

July 18, 1989

The Honorable Glenn English, Chairman
Subcommittee on Conservation, Credit
and Rural Development
House Committee on Agriculture
1301 Longworth House Office Bldg.
Washington, DC 20515

Dear Congressman English,

This letter explains why we favor dual trading on the Coffee, Sugar & Cocoa Exchange.

For perspective, the writer has been a member of CSCE since 1945. This makes me the oldest active member in seniority. I have served on the Exchange Board and many Exchange Committees, although I have never been a floor broker or floor trader.

In my judgment, no valid reason so far has been shown why dual trading should be prohibited on this Exchange. On the contrary, we believe such a ban would importantly impair liquidity!

Please do not throw out the baby with the bath water.

Sincerely,

B. W. DYER & COMPANY

Daniel L. Dyer
Partner

DLD:ms

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tel. 201-569-1700 • telex: TRT 178080, 178175 • fax: 201-569-3016

Amerop
TRADING CORPORATION

The Honorable Glenn English
Chairman
Subcommittee on Conservation, Credit
and Rural Development
House Committee on Agriculture
1301 Longworth House Office Bldg.
Washington, DC 20515

July 31, 1989

Dear Mr. English:

We are writing you concerning the CFTC Reauthorization Bill introduced on July 12.

As a large futures commission merchant company which uses the Coffee, Sugar & Cocoa Exchange every day, we strongly feel that the CFTC Reauthorization Bill will prove harmful to the CSCE and the other commodity exchanges in the United States if passed. The Bill would induce a loss of liquidity which is an essential factor to the proper functioning of any exchange. This, in turn, would diminish the volume reducing the Market's viability as a hedging tool.

Moreover, the Bill presents provisions that are redundant to the existing regulatory powers of the CFTC, and asks for a reauthorization of appropriations every two years, which is too frequent to allow the CFTC to conduct its regulatory mission effectively and impartially.

We hope you will agree with us that the CFTC Reauthorization Bill will do more harm than good to the US futures industry. Meanwhile, we are available for any questions you may have.

Sincerely yours,

Douglas Felton
President

Amerop
SUGAR CORPORATION

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tel. 201-569-1700 • telex: TRT 178080, 178175 • fax: 201-569-3016

The Honorable Glenn English
Chairman
Subcommittee on Conservation, Credit
and Rural Development
House Committee on Agriculture
1301 Longworth House Office Bldg.
Washington, DC 20515

July 31, 1989

Dear Mr. English:

We are writing you concerning the CFTC Reauthorization Bill introduced on July 12.

As a large sugar trading company which uses the Coffee, Sugar & Cocoa Exchange every day, we strongly feel that the CFTC Reauthorization Bill will prove harmful to the CSCE and the other commodity exchanges in the United States if passed. The Bill would induce a loss of liquidity which is an essential factor to the proper functioning of any exchange. This, in turn, would diminish the volume reducing the Market's viability as a hedging tool.

Moreover, the Bill presents provisions that are redundant to the existing regulatory powers of the CFTC, and asks for a reauthorization of appropriations every two years, which is too frequent to allow the CFTC to conduct its regulatory mission effectively and impartially.

We hope you will agree with us that the CFTC Reauthorization Bill will do more harm than good to the US futures industry. Meanwhile, we are available for any questions you may have.

Sincerely yours,

Mark Flegenheimer
Vice President

TELEPHONE: 212-269-4600
TELEX: ITT 420698
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ENERGY: 269-8731
FACSIMILE:
SUGAR: 212-269-9344
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Czarnikow Futures Inc
75 WALL STREET NEW YORK NY 10005

July 25, 1989

The Honorable Glenn English
Chairman
Subcommittee on Conservation,
Credit and Rural Development
House Committee On Agriculture
1301 Longworth House Office Building
Washington, D.C. 20515

Dear Congressman English:

As a member of the Coffee, Sugar & Cocoa Exchange Inc. and a member of its Board of Managers, I am very much interested in the bill introduced by you which would reauthorize the Commodity Futures Trading Commission. Of particular interest are the dual trading and audit trail features. I am avidly opposed to the proposed banning of dual trading in any contract with an average daily volume of 7000 contracts or more. Such a ban would severely affect liquidity and curtail trading on our exchange and would be detrimental to the best interests of the exchange, its members and their customers. In addition in my opinion there is no justification for the costs and inconvenience required to convert to a 30 second timing system.

I urge you as Chairman of the sub-committee considering this legislation to pay heed to the position of the Board of Managers of the Coffee, Sugar & Cocoa Exchange Inc. as presented to you by the Exchange management as well as to my positon as explained herein.

Thank you in advance.

Yours very truly

CZARNIKOW FUTURES INC.

R. J. Haller
President

RJH:jmo'd

STATEMENT SUBMITTED BY

DANIEL R. HUBER
CARGILL INCORPORATED

BEFORE THE
HOUSE AGRICULTURE SUBCOMMITTEE
ON
CONSERVATION, CREDIT AND
RURAL DEVELOPMENT
JULY 20, 1989

My name is Dan Huber. I am a Group Vice President with Cargill Incorporated, Minneapolis, Minnesota.

Cargill merchandises and processes agricultural and other commodities. We make significant use of futures markets for hedging purposes. I emphasize that the views I express in this statement stem from Cargill's experience as a commercial hedger.

When we and other commercial interests use futures markets to hedge some of our price risks, we require that those markets provide two things: liquidity and integrity.

We need markets with enough volume and open interest so that we can enter them and exit from them without creating undue volatility. We need markets with sufficient volume throughout all the months traded so that we can move or spread those hedges from nearby months to deferred positions.

Commercial users, as well as the public, also need to have absolute confidence in the integrity of the markets. We want to know that our orders will be honestly executed.

We compliment the Chairman and members of this subcommittee for focusing legislation reauthorizing the CFTC on these twin goals. We support the general thrust of your efforts and will focus our comments on the balance that needs to be struck in pursuit of the twin goals of integrity and liquidity.

DUAL TRADING

Dual trading -- the practice whereby a floor broker may trade for his own account or fill customer orders during the same time period -- is an important factor that helps provide market volume and liquidity. The proposed legislation clearly recognizes this. There is nothing inherently evil about dual trading.

In fact, at Cargill we prefer that the independent floor brokers we use to execute our orders also trade for their own account. We find that this experience broadens their market view, gives them a better "feel" for the market and helps them develop execution strategies for our orders that lead to better fills.

Limiting or eliminating dual trading promises other costs as well. Usually the best brokers are found in the most active pits, trading the most active months. Thus they are the ones who may be forced to choose between handling customer business or trading for themselves.

Unless a broker can be assured of handling large customer accounts, his own best interest may well cause him to trade for himself. This might not impact Cargill. But it will certainly limit the access of smaller commercial firms and the public to the most accomplished brokers. It will impose costs on such interests either in the form of poorer fills or higher brokerage rates or both.

The most common justification for dual trading concerns its effect on volume. There can be no doubt that dual trading adds to volume and liquidity in important ways. This legislation attempts to deal with this by eliminating dual trading in already heavily traded commodities options, but allowing it in lower volume markets.

Yet, we remain concerned that this partial ban will harm our ability to spread our hedges from nearby to more deferred contract months, especially since we may not be able to use the same broker on both sides of the spread. This is extremely important for any commercial hedger.

If the proposals before this subcommittee become law, we expect to give our independent floor brokers the necessary written exemption to allow them to dual trade. We are reluctant to lose the direct advantage of the better executions we experience from the dual trader. We believe others feel -- and would act -- likewise.

Still, this may not be adequate to ensure needed liquidity in a contract. We would hope that the legislative language would be modified to emphasize that the primary objective is for exchanges to demonstrate to CFTC that they can audit and manage the dual-trading process. If a 7000-contract (or some higher number) level is retained in the bill, the legislative history should indicate that the CFTC should regard the contract level merely as a guideline and that it should be prepared to use discretion to permit dual trading where added liquidity is useful and where other adequate means exist for preventing abuses.

AUDIT TRAILS, SURVEILLANCE AND ENFORCEMENT

In creating the CFTC in 1974, Congress placed primary responsibility for regulation of the futures markets in the hands of the exchanges and the industry, subject to the agency's oversight. Cargill supported this approach in 1974, and we continue to support it today.

We applaud this subcommittee's attention to the need to detect trading practices abuses, to enforcement of the rules and to uniform disciplinary action against those who break the rules. Cargill believes that the reauthorization process can provide a constructive opportunity to examine the performance of existing regulations and the need for refinements to those requirements.

One area of major attention has been the detection of market abuses through audit trails. The exchanges have made substantial progress in meeting audit trail requirements that are already in place. These audit trails are in the self interest of the exchanges, market users and the public. The CFTC can play a constructive role in assuring that these efforts to develop fully verifiable audit trails continue to progress.

Exchanges and the CFTC also should continue to vigorously enforce existing rules. For example, the only abuse that might stem from dual trading is "front running" ahead of customer orders. But the practice is proscribed by Broker Conduct rules 350.5 (A and B) at the CBOT. Other exchanges have similar rules.

Market expertise of CFTC surveillance personnel also can be improved. We believe that an understanding of the "cash" or "physicals" market that underlies a futures contract is essential for those who police futures.

Exchanges also should be required to ensure that their business conduct and investigative committees have expertise in the appropriate "cash" markets that underlie the futures contract.

CFTC also should require exchanges to set industry-wide standards for levels of abuse, disciplinary actions and punishment. This legislation provides useful momentum in that regard.

We believe that these suggestions, along with certain others contained in the bill, will do much to ensure the market integrity that is the goal of all. Improvement in the way that futures markets are managed by the exchanges and the CFTC can be achieved, we believe, without damage to that other goal of liquidity. In fact, as public confidence in market integrity grows, liquidity also will grow. That is the most effective way to achieve both goals.

Thank you.

- ## -

JPMorgan

July 14, 1989

The Honorable Glenn English
2206 Rayburn House Office Building
Washington, DC 20515

Dear Representative English:

It was a pleasure having the opportunity to meet with you over breakfast several weeks ago. We appreciated your visit to J.P. Morgan, and the insights you shared with us.

We also appreciated your openness to further input on the issues covered during the breakfast. Since your visit, we have had the chance to reflect on some of these areas. This letter will convey our thoughts on dual trading, broadening the role of state securities administrators for commodities enforcement, the CFTC's proposals regarding hybrid and related instruments, and formalizing the role of the Working Group.

1. Dual Trading: We are pleased by the proposals you have introduced to deal with potential front-running and the conflicts of interest inherent in the practice of dual trading. Your recommendation to prohibit dual trading in any contract market that has a daily average volume of 7,000 contracts or more is a thoughtful compromise. It would instantaneously eliminate this potential for front running and conflict of interest problems in approximately 90% of futures trading volume. At the same time, it would leave the dual trading practice in place in smaller volume contracts, which arguably need the additional liquidity. Based on 1988 statistics, we estimate that approximately 60 futures contracts would not have been affected by the dual trading limitations, but those contracts represent only about 10% of total futures volumes.

   We have given some thought to whether the 7,000 per day limitation should be raised or lowered. Interestingly, we note that if the average daily trading limit was raised to 10,000 contracts, only two additional markets would gain dual trading rights — live hogs and copper (again based on 1988 statistics). Under this more relaxed limitation, approximately 89% of total futures trading volume would still have been protected from abuse under the dual trading ban.

On the other hand, there are nine contract markets which trade in the range of 5,000 to 7,000 per day. If the dual trading ban is applied to contracts trading in excess of 5,000 per day, almost 96% of all futures trading volume would then be captured under the rule.

The 5,000 to 10,000 range seems to be the right order of magnitude. Within that range, the choice of a precise cutoff limit becomes a matter of judgment. We might argue that the limit first be tried at a 10,000 daily volume level so as to test the impact on liquidity, assess the effectiveness of the dual trading ban, provide maximum opportunity for smaller volume contracts to prosper, and encourage the development and growth of new contracts for global competitiveness. Adjustment to the cutoff level could then be made with better empirical evidence than we have today.

2. CFTC Regulation of Hybrid and Related Instruments: J.P. Morgan, individually and through the New York Clearing House Association (NYCH), has provided extensive commentary to the CFTC on its proposed regulations for hybrid and related instruments. Copies of the submissions of J.P. Morgan and the NYCH to the CFTC are attached to this letter for your review. Some of the salient points from that submission are:

   a. Hybrid instruments that are securities or are issued by banks (and are therefore, in both cases, governed by other federal and/or state statutes and regulations providing for substantial investor protection) are not futures or options under the Commodity Exchange Act, and the CFTC has no jurisdiction over these instruments.

   b. In light of the substantial protection provided to investors in hybrid instruments which are securities or bank products and the lack of any identifiable problems (such as fraud or sales practice abuses) resulting from the sale and marketing of these instruments, there is no policy reason or regulatory justification for additional regulation by the CFTC.

   c. The practical impact of the proposed regulations will be to place U.S. financial institutions at a competitive disadvantage to their foreign counterparts who, for the most part, are not restricted in offering to their customers products (in particular, deposit instruments) which are indexed to measures of value other than traditional interest rates.

d. The proposed regulations will also have the effect of restricting product innovation in the U.S. and impeding the ability of U.S. financial institutions to tailor new products to meet the demands of a rapidly changing market.

e. The CFTC should attempt to harmonize the statutory and regulatory exclusions and exemptions provided by the forward contract exclusion, the so-called Treasury Amendment and the trade option exemption so as to provide a safe harbor for off-exchange, privately negotiated commercial transactions between sophisticated institutions and members of the financial services industry.

3. Role of State Securities Administrators in Commodities Enforcement: In our discussions, you expressed concern about the need to assure effective enforcement of Commodity Exchange Act provisions, especially as they serve to protect small individual participants in the market. You noted the difficulty of assuring that agencies with limited resources — including the CFTC as well as federal and state prosecutors — are able to pursue effectively all serious commodities enforcement matters. You noted that some have recommended a broader role for the state securities administrators in carrying out provisions of the federal commodities laws.

   We share the concerns you raised and believe it is important that effective enforcement be achieved if the credibility of the commodities markets is to be preserved. We strongly urge you, however, to find a means to enhance enforcement capabilities that does not require an expanded role for the state securities administrators. We believe it would be a serious mistake to follow the model of U.S. securities regulation and establish two separate regulatory structures, one at the federal level and one at the state level. We are informed by associates at J.P. Morgan Securities Inc. that the dual structure of securities regulation frequently proves unnecessarily cumbersome and duplicative. It is especially difficult to coordinate the approvals of dozens of states when doing a large securities offering or qualifying a broker-dealer to do business nationally. This dual structure also can complicate participation in international offerings by U.S. broker-dealers, placing U.S. firms at a competitive disadvantage.

For these reasons, we believe it would be a serious mistake to expand the role of state securities administrators under the federal commodities laws.

4. Working Group: We were greatly pleased by the creation of the White House Working Group on Financial Markets in late 1987. It made great sense to bring together senior officials from the Treasury Department, the CFTC, the SEC, and the Federal Reserve. While members of the group were not always unanimous in their recommendations, the general tone of the group's recommendations seemed appropriate and correct to us.

   But quite apart from the substance of the group's recommendations, we strongly believe that the commodities and securities regulators should have a regular, formalized forum for coordinating their regulatory efforts. The all-important issues of financial integrity, trading halts, product listing, jurisdiction, etc. need to be reconciled among the various commodities and securities exchanges and, critically, at the regulatory level. Obviously, we think that formalizing the role of the Working Group is a good first step to greater integration of securities and commodities regulation of financial markets.

We hope these thoughts are useful to you and we look forward to getting together again in Washington or New York. If you or your staff would like to discuss any of these ideas further, please feel free to contact me at your convenience.

Sincerely,

Attachments

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June 29, 1989

Congressman Glenn English
Chairman of the Agricultural SubCommittee
On Conservation, Credits and Rural Development
1301 Longworth House Office Building
Washington, DC 20515

Dear Mr. English:

Through the media, I have read reports considering the elimination of dual trading in futures contracts on agricultural commodities. I have a concern that eliminating dual trading will take away certain efficiencies in place in the market presently.

I strongly suggest that your House SubCommittee look at avenues of detection and penalties for abuses of dual trading through the exchanges and regulatory agencies rather than eliminating the process of dual trading in commodity contracts.

The system has worked efficiently for many, many years, and I hope that we can keep a successful system intact and weed out the abuses through detection on the exchange level.

Please give this consideration in your Committee activities.

Sincerely,

Joe Lucas
Merchandiser

CALUMET
893-2245

GEARY
884-2921

EL RENO
262-4288

OKARCHE
263-4566

TESTIMONY

OF

SARAH VOGEL

AGRICULTURE COMMISSIONER

NORTH DAKOTA

TO

THE HOUSE AGRICULTURE COMMITTEE

AGRICULTURE SUBCOMMITTEE ON CONSERVATION CREDIT AND RURAL DEVELOPMENT

Representative Glenn English, Chairman

July 20, 1989

This testimony concerns my objections to the manner in which the Chicago Board of Trade (CBOT) exercised its supervisory and regulatory role in issuance of an Emergency Order (the Order) on July 11, 1989 pertaining to the July soybean contract. (Attachment 1).

The major points in this testimony are as follows:

1. No contract market should be allowed to issue emergency orders without releasing to the public, as well as to the Commodities Futures Trading Commission (CFTC) the specific reasons why the action is being taken. Congress and this subcommittee should demand that the CFTC immediately release to the public the "detailed explanation" by the CBOT of the reasons for its July 11 emergency order. This explanation should be available from

the CFTC because the law (Section 5a) requires any contract agency who uses the authority to issue an emergency rule must give a detailed explanation to the CFTC upon exercise of that authority.

2. The CFTC should have the means and the will to investigate and prosecute insider trading. The CFTC should closely examine the CBOT's use of "polling" Board members for conflict prior to issuance of the Order.
3. Because the use of the emergency order authority bypasses normal CFTC oversight and advance public notice, authority to use emergency orders should be predicated by a close evaluation of the suitability of the remedy. In the case of the July 11 CBOT Order, it appears that the CBOT's remedy did not preserve fair and orderly trading, but rather destroyed it.
4. The CBOT board and committee members and employees have an excessively liberal legal and monetary indemnification policy. It should be narrowed so that self-indulgence does not replace self-policing.

1. DISCLOSURE OF THE SPECIFIC REASONS FOR THE ORDER.

As stated in the Order, the CBOT acted on the basis of an "emergency". The Order, however, totally failed to describe the emergency which allegedly threatened "fair and orderly trading". It gave no facts and no reasons for its conclusion that an emergency existed. (See Attachment 1)

In the days since the CBOT's action, rumors have swirled around the country that the Order was issued at the behest of CBOT members who were in a short position on July soybean contracts. The principal name mentioned in the press reports is Cargill (see, for example, the Wall Street Journal, July 13, 1989, p. C1). These traders, of course, stood to gain if the market collapsed--as it did. There is nothing to rebut these rumors at this point.

Therefore, I recommend that the Committee mandate that the CFTC require the CBOT, as well as other contact markets, to issue to the public a statement fully explaining the specific facts surrounding and reasons for any emergency order. No authorization to issue emergency orders should be allowed without requiring simultaneous public disclosure of the reasons for the order. The facts and specific reasons I would like to see included in a public explanation would be the names of the companies and officials involved, the specific conduct that was the trigger of the order, the harmful consequences that would ensue unless the order were issued and, finally, the manner in which the remedy being applied will prevent those harmful consequences and preserve confidence in the market.

Only this type of public disclosure would be sufficient to dispel the perception, which now appears to be based on fact, that the CBOT is a private club run in secrecy for the best interests of its powerful trader members.

This disclosure is not a radical step. Section 5a of the Commodity Futures Trading Act now requires any contract market to provide the CFTC (but apparently not the public) with a "complete explanation of the emergency involved." (Attachment 2)

Moreover, at the hearing today, this Committee should demand full release of the Section 5a explanation that presumably was received by the CFTC on July 11, 1989 Emergency Order. This explanation should then be widely distributed so that the CBOT action can be fully evaluated.

2. SELF DEALING/INSIDER TRADING

The CBOT emergency order was alleged to have been leaked before the close of the trading day on July 11, 1989--even though the order was not released until after closing.

The following two paragraphs from the July 17, 1989 Wall Street Journal are very provacative:

> "The board is also fending off rumors that news of its liquidation order might have leaked out before the close of trading Tuesday. Exchange officials have said that all the directors that voted on the action were polled to ensure officials have said that all the directors that voted on the action were polled to ensure that none had a position in the July contract.
>
> Burton Gutterman, Chief Executive Officer of Index Futures Group, Inc. and a CBOT director, said he was the only director to excuse himself from the decision.

The questions that immediately come to mind are:

1) How long had the CBOT discussed this major action before they took the vote? According to the attached chart, the market fell precipitously from just before July 7 to the present.

2) What action did the CBOT take to ensure that excluded CBOT directors, such as Mr. Gutterman, did not go to the floor and act on the knowledge that an emergency order decision was pending?

3) Who checked up on the veracity of the CBOT's self-administered and self-imposed "poll" of self interest?

4) Given the need for absolute secrecy, how much time did the CBOT directors have to assimilate the facts of the alleged squeeze before acting? Was that time adequate?

5) Which staff members or other persons made the recommendations for the emergency order to the CBOT Board and what control was there over those persons' self-interest and potential for self-dealing?

In contrast, to the apparent preternatural awareness of various traders involved with the CBOT, compare the shock to the farmers who were also affected by the order. The July 17, 1989 Wall Street Journal stated:

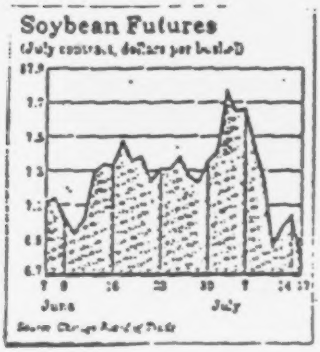
> "It's [the CBOT's] reputation is reeking among small investors. . . .
>
> 'It makes us look like crooks," said John J. Heber, a grain commodity advisor in Redfield, South Dakota. 'We'll lose business over time.' The wild price fluctuations triggered by the Board's action forced Mr. Heber to ask about 80 farmers for more money to back their positions. Many of them had never used futures contracts before he opened shop two years ago, and they are angry now that they tried it."

It is crucial that this Committee ensure that the CFTC prevents and punished "insider trading" and also prevents appearance of potential for insider trading. The CBOT's "poll" of its directors reeks of insider trading potential.

3) Was the "cure" worse than the disease?

The "squeeze" that the newspapers have described at the basis of the CBOT's order, involved around one percent of annual U.S. production of soybeans (23 million bushels of a 2 billion bushel crop.)

High prices, from a farmer's perspective, are a positive, not a negative. It appears that the CBOT does not show this view.



Source: Wall Street Journal (7-18-89)

The chart printed above shows a June through early July gradual rise in prices. It appears that the market prior to the CBOT action was a much more "orderly" market than the market after the CBOT order.

The remedy chosen by the CBOT was drastic, abrupt sales of all positions in excess of 1 million bushels, whether for hedging or speculative purposes, in a very short timeframe. This "remedy" has had an unbelievably disruptive effect on the July contract, other soybean contracts and the cash price of soybeans and other crops. Corporations and individuals and domestic and foreign buyers have been affected. The credibility of the CBOT and other contract markets has also been hurt, in the same manner as an embargo.

It is hard to imagine what greater chaos could have been caused by the undescribed "emergency" that the CBOT sought to prevent!

Congress should require that contract markets' authority to use emergency orders under 17 CFR 1.41 (f) should involve only measured remedies carefully tailored to the alleged harm and should disallow remedies that cause greater harm to the public than the harm sought to be prevented. The broad "menu" of remedies allowed by Section 5A of the Act and 17 CFR 1.41(3) (f) should be preceeded by better defined guidelines and restrictions. Also, fines to disgorge ill-gained profits by specific firms should be explored in lieu of remedies that punish the innocent as well.

4) Indemnification of CBOT directors, officers, committee members and employees.

The honesty of a largely self-policing board such as the CBOT rests, in part, on individual members' evaluation of risk to be incurred by an improper action versus a potential profit to be made.

CBOT Rule 182.00 provides free legal counsel and complete indemnification for all directors, officers, committee members and employees. Only where a court in a judgment or a majority of the CBOT Board or a lawyer (if the majority of the CBOT Board is disqualified) in a settlement finds that the director or other person was derelict or guilty of gross negligence or willful misconduct would that soon be excluded from this policy.
(Attachment 3)

As this Committee may know, soybean farmers are contemplating legal action based on injuries casued to them by CBOT's order. It is obvious that even CBOT members who may have acted willfully or in a grossly negligent manner will have unlimited free legal counsel during the lawsuit. Moreover, if CBOT members are found to be negligent but not grossly negligent they will be fully compensated by the CBOT.

Congress should narrow the virtual invitation to abuse that CBOT Rule 182 represents. While board members need protection from frivolous lawsuits, the public also needs better protection from bad actors in contract markets.

Thank you for the opportunity to present these views.

(Attachments follow:)

ATTACHMENT #1

Chicago Board of Trade

EMERGENCY RESOLUTION OF THE BOARD OF DIRECTORS OF THE BOARD OF TRADE OF THE CITY OF CHICAGO RELATING TO THE JULY 1989 SOYBEAN FUTURES CONTRACT; ADOPTED PURSUANT TO ASSOCIATION RULE 180.00 AND REGULATION 180.02, COMMODITY EXCHANGE ACT SECTION 5a(12), AND CFTC REGULATION 1.41(f).

RESOLVED, that the Board of Directors of the Board of Trade of the City of Chicago hereby determines that an emergency exists with regard to the July 1989 soybean futures contract traded on the Exchange that requires immediate action and threatens or may threaten fair and orderly trading in, the liquidation of, and delivery pursuant to, the July 1989 soybean futures contract, and hereby adopts the following measures to deal with this emergency:

(1) Effective as of the opening of the market on July 12, 1989, any person or entity, either alone or in conjunction with any other person or entity, who owns or controls a gross long or gross short position for any purpose whatsoever in excess of three million bushels in the July 1989 soybean futures contract traded on the Exchange must reduce said position and subsequent positions by at least 20% per trading day subject to the following absolute limits.

No person or entity, either alone or in conjunction with any other person or entity, shall own or control a gross long or gross short position for any purpose whatsoever in the July 1989 soybean futures contract traded on the Exchange in excess of three million bushels as of the close of trading on Tuesday, July 18, 1989.

No person or entity, either alone or in conjunction with any other person or entity, shall own or control a gross long or gross short position for any purpose whatsoever in the July 1989 soybean futures contract traded on the Exchange in excess of one million bushels as of the expiration of trading on Thursday, July 20, 1989.

This resolution is applicable to all positions, whether hedge or speculative.

(2) Failure by any member or member firm to comply with this Emergency Resolution, or failure to assist in compliance with this emergency resolution including as directed by the Executive Committee pursuant to paragraph (3) below, shall be deemed to be an offense against the Association and an act detrimental to the interest and welfare of the Association.

LaSalle at Jackson
Chicago, Illinois 60604
312 435 3500

(3) The Executive Committee is authorized and empowered to take all steps it deems necessary in its sole discretion to assure compliance with this Emergency Resolution, including but not limited to the ordering of the liquidation on the Exchange (by brokers selected by the Committee in its discretion) of the July 1989 soybean futures position of any person or entity not in compliance with paragraph (1) above, to the extent of such noncompliance. The direction of the Executive Committee ordering liquidation on the Exchange shall be deemed for all purposes, including under the rules and regulations of the Association, to be the act of the person or entity whose position is being liquidated.

(4) Nothing in this Emergency Resolution shall be deemed in any way to preclude the Association from imposing sanctions on any member or member firm for any violation of Association rules or regulations, or this resolution, in connection with July 1989 soybean futures.

(5) This Emergency Resolution is expressly adopted pursuant to Association Rule 180.00 and Regulation 180.02, Section 5(a)(12) of the Commodity Exchange Act, and CFTC Regulation 1.41(f).

(6) Nothing herein shall be deemed to preclude the Business Conduct Committee or the Board of Directors from taking such further action, pursuant to the authorities referenced in paragraph (5) above or otherwise, as may be necessary in the Committee's or the Board's judgment to further provide for orderly trading and liquidation of July 1989 soybean futures and delivery pursuant thereto.

Date: July 11, 1989

Karsten Mahlmann

Karsten Mahlmann,
Chairman of the Board,
Board of Trade of the City
of Chicago

ATTACHMENT #2

[¶ 1222] **[Commission Approval of Contract Market Rules]**

Section 5a (12) except as otherwise provided in this paragraph, submit to the Commission for its prior approval all bylaws, rules, regulations, and resolutions ("rules") made or issued by such contract market, or by the governing board thereof or any committee thereof, that relate to terms and conditions in contracts of sale to be executed on or subject to the rules of such contract market, as such terms and conditions are defined by the Commission by rule or regulation, except those rules relating to the setting of levels of margin. Each contract market shall submit to the Commission all other rules (except those relating to the setting of levels of margin and except those that the Commission may specify by regulation) and may make such rules effective ten days after receipt of such submission by the Commission unless, within the ten-day period, the contract market requests review and approval thereof by the Commission or the Commission notifies such contract market in writing of its determination to review such rules for approval. The determination to review such rules for approval shall not be delegable to any employee of the Commission. At least thirty days before approving any rules of major economic significance, as determined by the Commission, the Commission shall publish a notice of such rules in the *Federal Register*. The Commission shall give interested persons an opportunity to participate in the approval process through the submission of written data, views, or arguments. The determination by the Commission whether any such rules are of major economic significance shall be final and not subject to judicial review. The Commission shall approve such rules if such rules are determined by the Commission not to be in violation of this Act or the regulations of the Commission and the Commission shall disapprove, after appropriate notice and opportunity for hearing, any such rule which the Commission determines at any time to be in violation of the provisions of this Act or the regulations of the Commission. If the Commission institutes proceedings to determine whether a rule should be disapproved pursuant to this paragraph, it shall provide the contract market with written notice of the proposed grounds for disapproval, including the specific sections of this Act or the Commission's regulations which would be violated. At the conclusion of such proceedings, the Commission shall approve or disapprove such rule. Any disapproval shall specify the sections of this Act or the Commission's regulations which the Commission determines such rule has violated or, if effective, would violate. If the Commission does not approve or institute disapproval proceedings with respect to any rule within one hundred and eighty days after receipt or within such longer period as the contract market may agree to, or if the Commission does not conclude a disapproval proceeding with respect to any rule within one year after receipt or within such longer period as the contract market may agree to, such rule may be made effective by the contract market until such time as the Commission disapproves such rule in accordance with this paragraph. The Commission shall specify the terms and conditions under which a contract market may, in an emergency as defined by the Commission, make a rule effective on a temporary basis without prior Commission approval, or without compliance with the ten-day notice requirement under this paragraph, or during any period of review by the Commission. In the event of such an emergency, as defined by the Commission, requiring immediate action, the contract market by a two-thirds vote of its governing board may immediately make effective a temporary rule dealing with such emergency if the contract market notifies the Commission of such action with a complete explanation of the emergency involved. [As added by Act of October 23, 1974 (Commodity Futures Trading Commission Act of 1974), Sec. 210, 88 Stat. 1401, effective July 18, 1975, pursuant to CFTC action under Sec. 1(c), 89 Stat. 77, as amended by Act of September 30, 1978 (Futures Trading Act of 1978), effective October 1, 1978, Sec. 12(1) and (2), 92 Stat. 865, 871, Act of January 11, 1983 (Futures Trading Act of 1982), effective January 11, 1983, Sec. 216(2), 96 Stat. 2294, 2306—2307; and Act of November 10, 1986 (Futures Trading Act of 1986), effective November 10, 1986, Sec. 110, 100 Stat. 3561.] ←

.01 **1978 amendment.**—*For historical comment on amendments made by the Futures Trading Act of 1978, see* ¶ 6525.001.

.02 **1983 amendment.**—*For historical comment on amendments made by the Futures Trading Act of 1982, see* ¶ 6525.001.

.03 **1986 amendment.**—*For historical comment on amendments made by the Futures Trading Act of 1986, see* ¶ 6525.001.

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17 C.F.R. 1.41(F)

submitted pursuant to section 5a(12) of the Act and Commission regulation 1.41(c). One copy of each such submission shall be furnished to the Commission at its Washington, D.C. headquarters and one copy shall also be transmitted by the contract market to the regional office of the Commission having local jurisdiction over the contract market.

(3) Notwithstanding the provisions of this paragraph (d), a contract market may submit any such rule to the Commission for its approval pursuant to the provisions of section 5a(12) of the Act and paragraph (b) of this section.

(4) The Commission may remit to the contract market, with an appropriate explanation where practicable, and not accept pursuant to this paragraph any rule which the Commission determines to be a rule that is not exempt from the provisions of section 5a(12) of the Act and paragraphs (b) or (c) of this section.

(e) *Membership changes.* Each contract market shall promptly furnish the Commission with written notification of any changes in its membership. Once copy of such notification shall be furnished to the Commission at its Washington, D.C., headquarters, and one copy shall be transmitted to the regional office of the Commission having local jurisdiction over the contract market.

1.41 (f) *Temporary emergency rules.* In the event of an emergency, a contract market, by a two-thirds vote of its governing board, may place into immediate effect a temporary emergency rule to deal with the emergency without prior Commission approval, and without compliance with the ten-day notice requirement pursuant to section 5a(12) of the Act and paragraphs (b) and (c) of this section, respectively, subject to the following provisions:

(1) A temporary emergency rule, including any modification thereof, may not extend beyond the duration of the emergency, as determined by the contract market, but in no event shall a temporary emergency rule, or any modification thereof, continue, without express Commission authorization, beyond 30 days after the temporary emergency rule is first put into effect. In no event shall a temporary emergency rule, or any modification thereof, remain in effect for more than 90 days after the temporary emergency rule is first put into effect.

(2) The contract market shall notify the Commission at its Washington, D.C., headquarters of the adoption, modification and termination of a temporary emergency rule by the fastest available means of communication. A written copy of each such temporary emergency rule, and any modification and termination thereof, shall promptly thereafter be furnished to the Commission at its Washington, D.C., headquarters, along with a complete explanation of the emergency and the action taken to meet the emergency; two additional such copies shall also be promptly furnished by the contract market to the regional office of the Commission having local jurisdiction over the contract market.

(3) A temporary emergency rule may provide for, or may authorize the contract market, or the governing board thereof or any committee thereof, to undertake actions necessary or appropriate to meet the emergency, including, but not limited to, such actions as:

(i) Limiting trading to liquidation only, in whole or in part, or limiting trading to liquidation only except for new sales by parties who have the commodity to deliver pursuant to such sales;

(ii) Extending or shortening the expiration date for trading in contracts;

(iii) Extending the time of delivery;

(iv) Changing delivery points;

(v) Ordering the liquidation of contracts, the fixing of a settlement price or the reduction in positions;

(vi) Ordering the transfer of contracts, and the money, securities, and property securing such contracts, held on behalf of customers by a member of the contract market to another member, or other members, of the contract market willing to assume such contracts or obligated to do so;

(vii) Extending, limiting or changing hours of trading;

(viii) Suspending trading; and

(ix) Modifying or suspending any provision of the rules of the contract market.

(g) *Physical emergencies.* In the event the physical functions of a contract market are, or are threatened to be, severely and adversely affected by a "physical emergency," such as fire or other casualty, bomb threats, substantial inclement weather, power failures, communications breakdowns, or transportation breakdowns, a contract market official, duly authorized to take such action for and on behalf of the contract market with respect to such a "physical emergency" pursuant to a rule of the contract market that has been approved by the Commission or has become effective pursuant to section 5a(12) of the Act and these regulations, may take any action authorized by such rule necessary or appropriate to deal with the emergency, including, but not limited to, suspending trading on the contract market. In no event, however, shall suspension of trading on the contract market by such a designated official continue in effect for more than five (5) days. If so authorized by such a rule of the contract market, the designated official may also order restoration

ATTACHMENT #3

Chicago Board of Trade
Rules

General

180.00 Emergencies—

(a) The Board, upon the affirmative vote of two-thirds of the members voting at a meeting where a quorum is deemed present and at least one-third of the full Board is physically present, may adopt an emergency Regulation or Resolution which shall supercede and supplant all contrary or inconsistent Rules, Regulations, Resolutions or Rulings. Notice of the adoption of an emergency regulation or Resolution shall be posted promptly on the floor of the Exchange.

(b) An emergency Regulation and Resolution shall expire upon the happening of any of the following events

  (i) the Board shall have voted to rescind the emergency Regulation or Resolution in the same manner as for its adoption,

  (ii) the Commodity Futures Trading Commission shall have failed to authorize the extension of the emergency Regulation or Resolution within thirty (30) days after its adoption for a period not to exceed sixty (60) additional days, or

  (iii) the Board or the Members of the Association shall have failed to adopt the emergency Regulation or Resolution in accordance with Rules 107.00 or 132.00 during the time period when the emergency is in effect.

(c) All Exchange contracts shall be subject to the exercise of these emergency powers by the Board as well as the exercise by the Clearing House of the powers reserved to it by its charter, bylaws and resolutions.

(d) The Term "emergency" shall include all emergency circumstances now or hereafter referenced in the Commodity Exchange Act and the regulations of the Commodity Futures Trading Commission thereunder, and all other circumstances in which an emergency can lawfully be declared by the Board

(e) Except as otherwise stated in an emergency Regulation or Resolution adopted hereunder, the powers exercised by the Board under this Rule shall be in addition to and not in derogation of the authority granted by the Rules and Regulations to a committee or officer of the Association to take action as specified therein

180.01 Physical Emergencies—In the event the physical functions of the Association are, or are threatened to be, severely and adversely affected by a physical emergency such as but not limited to fire or other casualty, bomb threats, substantial inclement weather, power failures, communications breakdowns, or transportation breakdowns, either the Chairman, the President, or in their absence a member of the Executive Committee or another officer of the Exchange, is authorized to take such action as he shall deem necessary or appropriate to deal with such emergency including but not limited to suspending and restoring trading in whole or in part, provided that no trading suspension shall continue for more than five days without the approval of the Board under Rule 180.00. *1978*

180.02 Emergency Actions Under Rule 180.00—Pursuant and subject to the provisions of Rule 180.00, the Board may take or direct such actions as it deems necessary or appropriate to meet an emergency, including but not limited to such actions as:

(a) limiting trading to liquidation only, in whole or in part;

(b) limiting trading to liquidation only, except new sales for delivery,

(c) extending or shortening the time for the expiration of trading,

(d) extending the time for delivery,

(e) ordering liquidation of contracts,

(f) ordering the fixing of settlement prices;

(g) ordering the reduction of positions,

(h) ordering the transfer of positions, and the money, securities and property securing such positions, held on behalf of customers by a member, to another member or members willing to assume such positions;

(i) extending, limiting or changing the hours of trading.
(j) suspending trading.
(k) changing or removing daily price fluctuation limits;
(l) modifying or suspending any of the Rules and Regulations.

181.00 ***Retirement***—The Board is authorized to adopt, maintain, amend, and terminate, from time to time, a plan or plans for the retirement of employees of the Association and its wholly owned subsidiary corporations and for the payment of pensions to such retired employees; provided, however that no such plan or plans shall be applicable to employees who are covered by a collective bargaining agreement pension plan, and provided, further, that no retired employee now receiving retirement compensation shall have his combined Government assistance and retirement compensation which was in effect prior to September 1, 1950, reduced as a result of any such plan or plans. *76*

182.00 **Indemnification of Directors, Officers and Employees**—Each person now or hereafter a Director, officer, committee member or employee of the Association, and his legal representatives, shall be indemnified by the Association against all liabilities, expenses, counsel fees and costs including costs or amounts of settlement, imposed upon or reasonably incurred by him or his estate in connection with or arising out of any claim, action, suit or proceeding to which he is or may be made a party by reason of his being or having been a Director, officer, committee member or employee of the Association (whether or not a Director, officer, committee member or employee at the time such expenses, costs or liabilities are imposed upon or incurred by him), and any person who, at the request of such Association, served as Director or officer or committee member or employee of another corporation in which such Association owned corporate stock, and his legal representatives, shall in like manner be indemnified by the Association so requesting him to serve; subject, however, in either case, to the following: (a) he shall have no right of indemnification in respect of any matter as to which he is finally adjudged in any such action, suit or proceeding to have been derelict or guilty of gross negligence or wilful misconduct in the performance of his duties as such Director, officer, committee member or employee, (b) if any such claim is settled before final judgment, or if in the adjudication of any such action, suit or proceeding there is included no finding in respect of any dereliction of duty or guilt of wilful misconduct or gross negligence in the performance of duty on the part of such Director, officer, committee member or employee, he shall be entitled to indemnification only upon a determination in good faith by a majority of the whole Board of Directors that such claim, action, suit or proceeding did not arise by reason of the dereliction, gross negligence or wilful misconduct of such Director, officer, committee member or employee in the performance of his duties as such; (c) no Director who shall or might have been a party to any such claim, action, suit or proceeding, or who shall have or have had any financial interest adverse to the Association in respect thereof, shall participate in such determination, (d) if a majority of the Directors of the Association shall be ineligible so to participate, the Director, officer, committee member or employee seeking indemnification shall be entitled thereto only upon an opinion of counsel, who shall be selected by the Board in the manner designated by it and whose charges for such opinion shall be paid by the Association, that such Director, officer, committee member or employee has not been derelict or guilty of gross negligence or wilful misconduct in the performance of his duties; and (e) the indemnification provided for in this Rule shall not extend to any liability of a Director, officer, committee member or employee of the Association, or other corporation in which the Association owns corporate stock, for counsel fees if the Association shall have been willing to furnish counsel of its own choice to defend such Director, officer, committee member or employee and in the judgment of the Board of Directors of the Association, or of counsel selected by the Board of Directors as provided in clause (d) above, there was no justification for such Director, officer, committee member or employee to engage counsel other than the counsel which the Board of Directors was willing to furnish. The right of indemnification herein provided shall not be exclusive of other rights to which any such person may be entitled as a matter of law. *85*

183.00 **Seal**—The seal of the Association shall bear a figure of Justice with a ship in the distance surrounded with the corporate name of the Association. *600*

westway
merkuria
CORPORATION

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MATTHEW D. STONE
President

July 31, 1989

The Honorable Glenn English
Chairman
Subcommittee on Conservation, Credit
and Rural Development
House Committee on Agriculture
1301 Longworth House Office Bldg.
Washington, DC 20515

Dear Mr. English:

We are writing you concerning the CFTC Reauthorization Bill introduced on July 12.

As a large coffee and cocoa trading company which uses the Coffee, Sugar & Cocoa Exchange every day, we strongly feel that the CFTC Reauthorization Bill will prove harmful to the CSCE and the other commodity exchanges in the United States if passed. The Bill would induce a loss of liquidity which is an essential factor to the proper functioning of any exchange. This, in turn, would diminish the volume thus reducing the Market's viability as a hedging tool.

Moreover, the Bill presents provisions that are redundant to the existing regulatory powers of the CFTC, and asks for a reauthorization of appropriations every two years, which is too frequent to allow the CFTC to conduct its regulatory mission effectively and impartially.

We hope you will agree with us that the CFTC Reauthorization Bill will do more harm than good to the US futures industry. Meanwhile, we are available for any questions you may have.

Sincerely yours,

Matthew Stone
President

SD

July 26, 1989

Rep. Glenn English, Chairman
House Subcommittee
Conservation, Credit & Rural Development
2206 Rayburn Office Bldg.
Washington, D. C. 20515

Dear Congressman: Re: CFTC reauthorization hearings

Since I did not receive sufficient notice to properly prepare testimony for the CFTC reauthorization hearings, I respectfully request that you include the following in the record relative to said hearings:

Mr. Chairman and members of your committee:

More than 50 years ago Congressional action provided regulations in the stock market which limited speculators to selling only on an "up-tick" of the market as a means of protecting stock investors and stock companies from demoralizing crashes in the market due to massive speculative short selling.

Proof that the "up-tick" rule is alive and well was evident in the May 26, 1989 Wall St. Journal, which reported that Salomon Brothers, Inc., was censured by the SEC May 25, 1989 after being accused of violating the "short sale" provisions of federal securities law in its trading during Black Monday, Oct. 19, 1987.

WSJ further stated: "Federal securities laws have long banned short sales on a °downtick', or a at a price below the last one reported for the stock. This is designed to keep traders from relentlessly driving down the price of a falling stock...the lead SEC attorney said the short sale rule has two purposes: to prevent downward manipulation of stock prices, and to prevent acceleration of a decline in a °stressed' market."

The crash in cattle prices in early 1986 following announcement of the Dairy Termination Program in which cattle futures prices dropped the limit on 11 out of 20 trading days, together with the recent fiasco in soybean prices, are sharp reminders that the time is way overdue for grain and livestock producers to be provided with similar protection against an unlimited number of speculators who can, under current futures trading regulations, sell futures contracts representing commodities they don't own at the time of sale, and which they sell at prices the actual owner never agreed to take! A ridiculous situation, to put it mildly!

I believe Congress has the authority to place much-needed limits on speculators in the commodities markets since the first paragraph of the Commodity Exchange Act of 1936, Sec. 4a, states: "An act to amend the grain futures act to prevent and remove obstructions and burdens upon interstate commerce in grains and other commodities by regulating transactions therein on commodity futures exchanges, to limit or abolish short selling, to curb manipulation, and for other purposes." (This law was sustained in legislative intent by the Futures Trading Act of 1978)

A report of the House Committee on Agriculture, entered in the Congressional Record on June 3, 1935 states: "The fundamental purpose of the measure is to insure fair practice and honest dealing in the commodity exchanges and to provide a measure of control over those forms of speculative activity which too often demoralize the markets to the injury of producers and consumers and the exchanges themselves."

I respectfully request that you and your Committee make a diligent effort to provide grain and livestock producers with the protection they need and deserve in the commodity pricing system by recommending either strict limits or abolishment of speculative short selling. Limits on dual trading, permanent reauthorization of the CFTC (the CFTC should be replaced by the SEC), or more accountable futures trading practices will do nothing in terms of protecting grain and livestock producers against grossly unfair speculative selling.

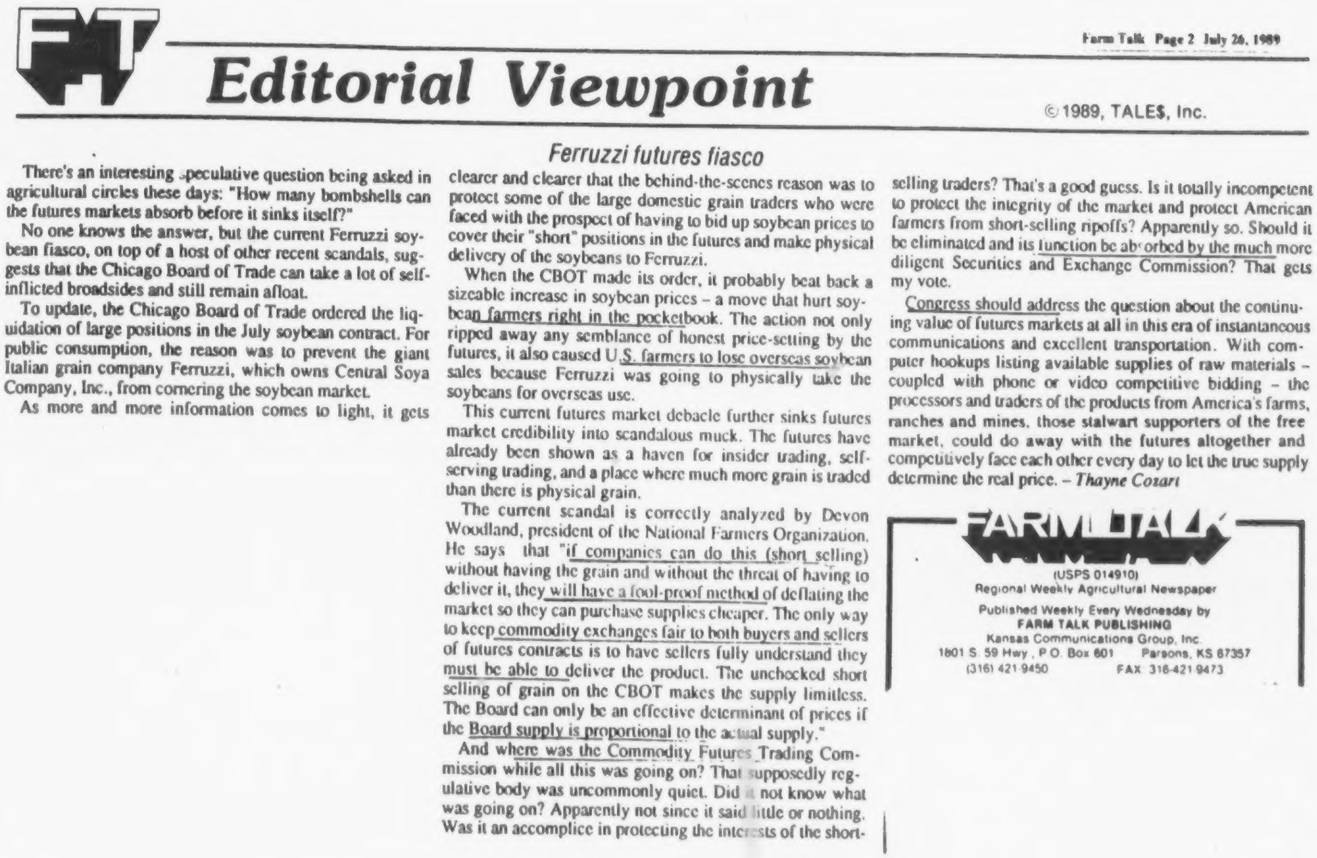
I am attaching a copy of an editorial from July 26, 1989 Farm Talk publication which provides some interesting and very constructive thoughts on the farm commodity pricing system. I request that you place that editorial in its entirety, along with my testimony, in the record.

Thank you.

Doug Wildin

Doug Wildin
Route 1
Hutchinson, Kansas 67501

P.S. If you have any hearings on futures again soon, I would like very much to participate if given ample notice. I hope they will be out here where other producers can participate.



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Editorial Viewpoint

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Ferruzzi futures fiasco

There's an interesting speculative question being asked in agricultural circles these days: "How many bombshells can the futures markets absorb before it sinks itself?"

No one knows the answer, but the current Ferruzzi soybean fiasco, on top of a host of other recent scandals, suggests that the Chicago Board of Trade can take a lot of self-inflicted broadsides and still remain afloat.

To update, the Chicago Board of Trade ordered the liquidation of large positions in the July soybean contract. For public consumption, the reason was to prevent the giant Italian grain company Ferruzzi, which owns Central Soya Company, Inc., from cornering the soybean market.

As more and more information comes to light, it gets clearer and clearer that the behind-the-scenes reason was to protect some of the large domestic grain traders who were faced with the prospect of having to bid up soybean prices to cover their "short" positions in the futures and make physical delivery of the soybeans to Ferruzzi.

When the CBOT made its order, it probably beat back a sizeable increase in soybean prices – a move that hurt soybean farmers right in the pocketbook. The action not only ripped away any semblance of honest price-setting by the futures, it also caused U.S. farmers to lose overseas soybean sales because Ferruzzi was going to physically take the soybeans for overseas use.

This current futures market debacle further sinks futures market credibility into scandalous muck. The futures have already been shown as a haven for insider trading, self-serving trading, and a place where much more grain is traded than there is physical grain.

The current scandal is correctly analyzed by Devon Woodland, president of the National Farmers Organization. He says that "if companies can do this (short selling) without having the grain and without the threat of having to deliver it, they will have a fool-proof method of deflating the market so they can purchase supplies cheaper. The only way to keep commodity exchanges fair to both buyers and sellers of futures contracts is to have sellers fully understand they must be able to deliver the product. The unchecked short selling of grain on the CBOT makes the supply limitless. The Board can only be an effective determinant of prices if the Board supply is proportional to the actual supply."

And where was the Commodity Futures Trading Commission while all this was going on? That supposedly regulative body was uncommonly quiet. Did it not know what was going on? Apparently not since it said little or nothing. Was it an accomplice in protecting the interests of the short-selling traders? That's a good guess. Is it totally incompetent to protect the integrity of the market and protect American farmers from short-selling ripoffs? Apparently so. Should it be eliminated and its function be absorbed by the much more diligent Securities and Exchange Commission? That gets my vote.

Congress should address the question about the continuing value of futures markets at all in this era of instantaneous communications and excellent transportation. With computer hookups listing available supplies of raw materials – coupled with phone or video competitive bidding – the processors and traders of the products from America's farms, ranches and mines, those stalwart supporters of the free market, could do away with the futures altogether and competitively face each other every day to let the true supply determine the real price. – *Thayne Cozart*

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